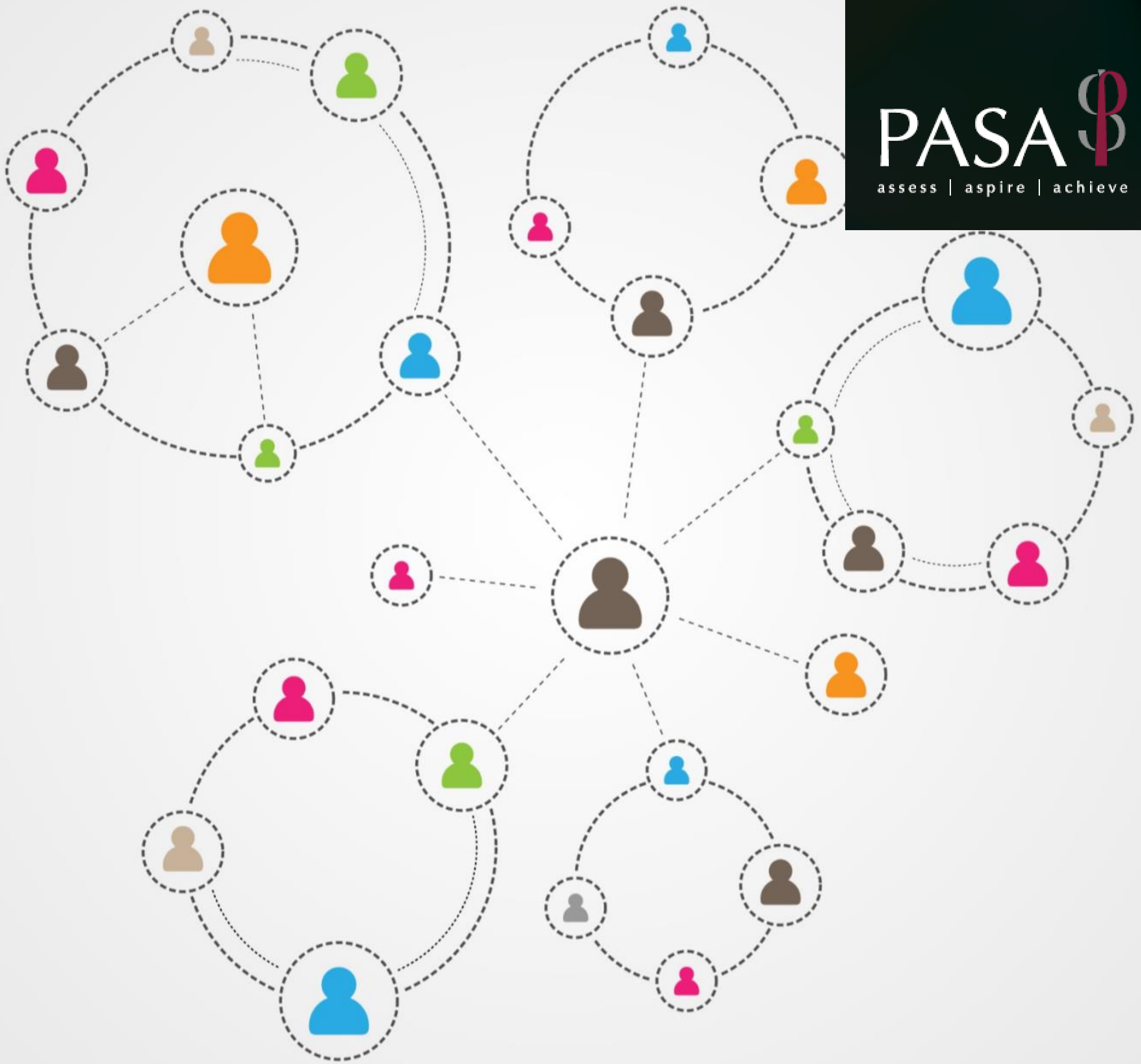

PASA Consultation Response

Future of the defined contribution pension market: the case for greater consolidation

July 2021

Consultation Response

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1. Introduction – About PASA

The Pensions Administration Standards Association (PASA) was created to provide an independent infrastructure to set, develop, guide and assess administration standards and raise the profile, development and perceived value of pensions administration, a previously undervalued sector of the pensions industry.

PASA acts as a focal point and engages with the industry and government to create protocols for understanding good administration - but also appreciates there's no one size fits all. PASA develops evidential accreditation practices which allows benchmarking across and between the industry regardless of how the administration is being delivered.

As well as raising the standard and profile of pension administration generally, PASA focuses on three core activities.

1. **Defining good standards of pensions administration relevant to all providers, whether in-house, third party or insurers**
2. **Publishing Guidance to support those standards**
3. **Being an independent accreditation body, assessing the achievement of good standards by schemes (regardless of provider)**

PASA is the only organisation providing such services across schemes, yet there's a demand for evidence of service quality from scheme trustees, sponsors, administrators, insurers, scheme members and regulators.

About PASA Accreditation

PASA Accreditation is open to all corporate members of PASA providing administration services (DB, DC, trust-based and contract-based schemes).

PASA Accreditation is granted following an independent evaluation and assessment process, which includes on-site visits and the review of documentation to evidence controls, procedures, process, staff development and contractual positions with clients.

Full details on PASA can be found by visiting www.pasa-uk.com

2. Consultation questions and responses

Question 1:

Do you agree that the government is right to aim for fewer, larger schemes going forward? Are there any risks?

Broadly yes but there are various associated risks which mean such an aim should be approached with caution. It's acknowledged schemes which aren't well managed or governed should consolidate into a scheme with a proven infrastructure to continue to maintain a high level of governance, Value for Members, and good member outcomes. However, there should be caution against simply focusing on the size of scheme and instead concentrate on the qualities, experience, knowledge, innovation and overall governance of the scheme, Trustee and Sponsor behind it. There are plenty of well run large DC schemes which don't need to be consolidated just because their AUM is of a certain size. Focusing on monetary benchmarks, such as fund size, costs, charges and AUM, detracts from the overall aim of having few, very well governed schemes, instead of an oligopoly of very large schemes with significant asset portfolios. The focus should be to address the issue of badly run or governed schemes, regardless of size.

We suggest focus is given to separating out those schemes which need consolidating from those which don't. It's important schemes under £100m which don't comply well now, are discovered and helped earlier on in the process. If they can't comply now, they won't in the future when there'll be further regulation. These schemes probably need more help during consolidation, but they fear their size means they won't be commercially attractive and therefore be left until last, when they should really be consolidated first. We feel the broad brush of sub £100m may help but there should be focus.

Fewer schemes would create an easier to regulate industry and therefore reduce the perceived risk of poor service, governance and outcomes for members. However, having a small number of very large 'mega' schemes could reduce the commitment to be innovative and competitive and instead prioritise the management and requirement to meet ever growing governance demands. This would stifle industry innovation and prevent new market entrants which could bring innovation, technology enablers and are possibly more relevant to todays savers.

Having few mega schemes which generate economies of scale may be able to obtain lower charges but this doesn't necessarily equate to better governance or outcomes for members. Nor does it mean these will be well-run schemes, but smaller schemes or new clients may still be drawn to them.

The Master Trust journey is still nascent and as it's not yet fully developed there's a risk fast consolidation could overwhelm and stifles the current evolution of creating robust and member focused pension arrangements. There's also the danger of rushing many concurrent implementations to support consolidation. This could result in data issues during migration and create on going servicing issues. Member disengagement caused by poor service is the opposite of the intention of this consultation.

An industry dominated by a few 'mega' schemes could be counterintuitive to the aim of providing better member outcomes and investments, as competition is reduced and the need to 'prove yourself' is diminished. Although larger schemes are more likely to have the resources to be innovative and improve investments, communications, etc, there would be less incentive for them to do so if the market and therefore the competition is reduced (and there's only a limited choice for consolidating schemes and new clients). Member outcomes should be the focus and this could be lost in large schemes where communications and engagement can become impersonalised.

The aim to create an industry of fewer 'mega' schemes relatively quickly could overload them, and their service providers, if high levels of consolidation occurred over a short period. There could be potential capacity issues in consolidation, which could lead to a need for the schemes to increase their prices/charges to meet the increased workload and demand. There would also be a need for increased liability insurance and the Financial Reserve required. Third party service providers such as legal advisers and investment consultants could also increase their fees, resulting in competition for which schemes can afford to continue. There's a risk of the mega schemes not offering the small consolidating schemes good terms due to their AUM and number of members with small pots. Or, as schemes over £5billion won't need to consolidate, they could then pick and choose which schemes are viewed as a good fit and reject those with small pots or which aren't cost effective. Consideration would then need to be given to what happens to those schemes. For example, are they pushed to NEST? In which case they don't have a choice.

The government has stated the drive for greater consolidation is better outcomes and value for members. We believe this would be better achieved with revising the process of consolidation to focus on quality schemes not necessarily big schemes.

Question 2:

What impact will the new value for members assessment have on consolidation of schemes under £100m? If you were a scheme that did not pass the value for members assessment, would you look to "wind up" or "look to improve" and how would you go about this? Beyond the value for money assessment, could government, regulators and industry accelerate the pace of consolidation for schemes under £100m?

As VFM statements haven't yet come into force it's hard to predict the impact they may have on smaller schemes. However, if the outcome is as the government expects it will drive the smaller schemes to consider consolidation sooner than they may have planned. This will have an impact on the market in a number of ways. Not only will it drive up demand for a suitable Master Trust but will also increase the demand for advice from scheme lawyers and advisors. We question whether the pensions industry has the capacity to deal with this increase in demand certainly over the short term. Further, will good value commercial terms be available in a market which may have capacity issues?

We feel a drive to consolidation could drive up risks for schemes. There could be a risk the right level of legal advice and support isn't available. The complexities of this type of project aren't always clear from the outset and the appropriate level of research and analysis should be completed before determining a future DC strategy.

Master Trust providers are at risk of having their capacity squeezed, their resource isn't just limited by the number of people and working hours available. Where pre-funding arrangements are in place, they will have a limited level of capital available to fund this and this could seriously impede the speed at which transfers can take place. As well as detract resources from executing on their improvement plans and service evolution.

As a result of increased demand, Master Trust providers will potentially be able to cherry pick schemes and competitive terms may not be as readily available. This could be a particular problem for small schemes which would probably benefit most by moving. For instance, a provider offered both a £1bn and a £50m scheme will more likely give preferential terms to the larger scheme. This could leave the smaller schemes unable to access the whole market, as they could be offered either less favourable terms or even potentially find they have no offers at all if there's no provider capacity at the time.

Question 3:

How can government incentivise schemes with assets between £100m to £5bn to consolidate?

Every scheme has differing governing documentation but generally the decision whether to move an occupational pension scheme to a Master Trust will be the sponsoring employers. Trustees have an important role to play in this process but will generally be required to agree to the move to a Master Trust, if only because it will require changes to the Trusts governing documents, but their focus will be to ensure due process has been followed and protecting members' accrued benefits.

The Government shouldn't seek to incentivise schemes to consolidate, instead there needs to be compelling reasons for this to occur. If there are no clear advantages for a scheme to consolidate, we suggest an alternative strategy would be more appropriate.

In order to assess whether there's an advantage in consolidating, the sponsoring employers and trustees will need to consider whether there are likely to be better member outcomes in moving to a Master Trust. The areas they should consider are:

1. Governance arrangements
2. Quality of the administration arrangements
3. Costs directly and indirectly borne by the members
4. Costs directly or indirectly borne by the sponsoring employers
5. Quality of communications/member engagement
6. Positive Net member returns (fund performance) from their investments

An annual report assessing commercial Master Trusts against these six areas highlighting the best, medium and worst case performance in each criteria would enable occupational pension schemes to make a considered comparison of providers in the Master Trust market when considering whether it's in their members overall interest for the scheme to consolidate.

Question 4.

Assuming a scheme wishes to consolidate, how significant are the barriers identified above? Are there others? How do barriers vary for medium-larger schemes? How can the government, regulators and industry remove these barriers?

It's likely Master Trusts will be able to cherry pick schemes and those of low value will potentially struggle to secure attractive terms. In our experience, some providers won't quote for smaller schemes if the average pot size is below a certain threshold and the market might become more polarised, perhaps creating a tiered system with those catering for the workplace savings vehicles which are more typically of auto enrolment schemes and those which will take on schemes with pot sizes above a certain value.

There are two aspects of costs – the cost of moving and the ongoing charges to members. Upfront charges are difficult to overcome as the exercise to transfer is rarely quick or straightforward. However, the costs to the employer are likely to be lower moving forward and this will mitigate long term cost impact. A DC strategy should also include all solutions – not just Master Trusts and some of these may be less expensive to implement.

Costs to members might go up if the administration is currently paid by the sponsoring employer, but this can be mitigated in some instances where a Master Trust splits the fee in the same way (admin and investment) or has a proportion of the fee supported by a member charge. Master Trusts could be encouraged to offer this option, which currently has limited application in the market.

Bespoke arrangements can be a problem but shouldn't be a deterrent as some are outdated. Some benefits, such as spouses' pensions can be reshaped – in this case converted into additional life cover which may be welcomed by members and others may just have to be removed, with members compensated in other ways.

Lay trustees alone are unlikely to be able to offer the same functionality, support or options to members available through a Master Trust. Having an active Employer Management Committee governance group can provide similar engagement within the organisation while retaining cultural identity. The level of knowledge and expertise within the committee would then be supported by the Master Trust provider and the employer's advisers.

Charging structures which differ for specific cohorts shouldn't prevent changing – creating an equitable scheme for all members is fairer and the permitted charging structures within the consultation will provide equality within the scheme.

From a tax perspective, there are certain tax protections members may have under a transferring scheme – in relation to protected tax free cash lump sums over 25%, and protected pension ages (ability to take pension benefits before age 55) – which could be lost if a members' benefits are transferred to a Master Trust and part of the members' benefits are retained in the transferring pension scheme. This may occur where part of a member's benefits might be retained in the transferring scheme because the member has both DB and DC benefits in the transferring scheme, or the member has some DC benefits with elements which can't be replicated in a Master Trust (such as with profits funds). The transfer to Master Trusts would be eased if the tax legislation could be amended so members can retain protection on benefits which are transferred to a Master Trust, even where it's just part of the benefits.

The legislation concerning the transfer of members' benefits without consent has been simplified in relation to a transfer of DC benefits to a Master Trust and this is very beneficial. However, we think further guidance could be given to trustees concerning whether there are situations when investments with a GAR or with-profits elements can be transferred without members' consent. There might be overall benefits for the member of transferring to a Master Trust even though the GAR/with-profits aspect is lost. This will of course require careful consideration and trustees would of course generally prefer to have member consent wherever possible.

How can government incentivise consolidation for schemes between £100m and £5bn especially where there may be a proportion of members who have smaller pots and therefore may be less attractive to receiving schemes? Could government incentivise trustees of both the merging and receiving schemes to take a mixed economy of smaller and larger pots – could this be provided by the market at a suitable cost, and without imposing additional cost consequences on members?

We question the rationale behind this question. In our experience, larger schemes with over £100m are likely to already have robust governance, lower costs and access to lower charges and educational tools. As such we don't believe they should be the immediate focus of any approach to consolidation.

Question 5

How can we mitigate any risks associated with scheme consolidation?

There are a number of risks associated with consolidation, a few of which we detail in our answers above. We see the risks as (but not limited to):

- Consolidation could lead to reduced cost/quality competition and therefore innovation from providers. If government encourages schemes over £1bn or more to consolidate, we anticipate some newer authorised Master trusts will be forced to consolidate again stifling competition, innovation and new entrants to the market.
- Capacity risk – depending on the timeline for consolidation we believe there may be capacity issues, and hence the volume of transitions would need to be managed carefully over time
- Systemic risk – resulting in greater concentration of not just providers, but systemic risk in infrastructure/application providers supporting much larger, but few schemes.

- Loss of direct employer support for third party provision
- Communications – possible reduced member engagement, confusion over merged/conflated deferred benefits
- Loss of member records/availability – we know from experience multiple transfers reduce the accuracy/completeness of records
- Secondary impacts – will the PI providers be able to offer sufficient cover – there are normally maximum limits in place even now

To help mitigate risks the following are essential:

- Communication with key stakeholders and relevant parties from the outset
- Clear setting of the scope of activities and responsibilities of key stakeholders and relevant parties
- Project management
    - Regular catch up calls
    - Clear project plan
    - Buy in from all parties on project timescales
- An understanding of any technical requirements which may complicate the transition, to ensure correct members are transitioned
    - Protections
        - A Day
        - LTA
        - Retirement age
    - Hybrid/linked benefits
        - Buy back at settlement processes agreed
        - Clear communication of benefits to members
- Secure portal to transfer data to new provider to mitigate risk of any data breach

Question 6:

What other international good practice exists?

The level of market concentration anticipated by this consultation appears to be heading in the direction of the Kiwi Saver or Australian Super. But the UK pensions market has developed in a completely different context to these and many other countries. There's also much greater connectivity between their tax and pension systems than in the UK.

Question 7:

How important is scheme consolidation in driving better member outcomes?

What more can government and industry do to move away from a narrow focus on low costs and charges to a broader assessment of value for money that encompasses investment strategies whether innovative or otherwise and overall net returns?

Anecdotally and from the few surveys on this subject in the short period of the recent evolution in DC provision, there's a feeling consolidation should naturally drive better outcomes (for all the reasons we've seen and heard stated over the years). However, the modern Master Trust market is very immature. Until we've passed through and emerged the other side, no one knows for certain. There are plenty of reasons to say consolidation may not drive the better outcomes hoped for.

Small pots will continue to be an issue and we know government is concerned about how these will impact, both people's outcomes and the infrastructure of the pension system. Consolidating significant numbers of small pots could disproportionally impact this population of members as they aren't commercially viable to any provider. Any approach to consolidation should factor in fair treatment of people with small pots. In our experience, small pots tend to make for small decisions; or at least decisions made in isolation. The ONS and FCA data states over 55% of pension pots are encashed entirely on first access (for the age band 55 to 64). Less than 30% move into drawdown and, of those who do, over 40% draw an income of over 8% - which is likely to be unsustainable given the current economic climate. To provide further context, part of the reason for these apparently poor outcomes can be attributed to the fact many people over the age of 55 will have multiple small pots. Decisions on how to access these multiple, smaller pots will often be made in isolation from each other. The support supplied by the pension provider or administrator will likely to reference only the pot they're responsible for. So, at the level of the pension scheme member or policyholder, multiple pots don't typically lead to optimal decision-making at the point of vesting.

At a scheme level, we recognise size brings benefits. Aside from the obvious buying power size can bring, there are other tangible benefits which can improve outcomes. The Pensions Regulator published a report (Defined Contribution trust-based pension schemes research – Technical report on the 2020 survey) demonstrating clearly the larger Master Trust schemes were adhering more closely to its governance standards than the smaller, own-trust arrangements, in almost all categories. In terms of standards of governance, larger schemes governance frameworks tend to perform better in almost all cases, suggesting size facilitates, and can attract, better standards of trusteeship, administration and management. This doesn't equate however to better net member returns and investment outcomes.

The same principle applies to communications, investment strategy and management, ancillary services (such as advice), operational support and even innovation.

A degree of competition is always in the interests of consumers, but the data shows bigger schemes tend to be better run. Fewer, larger schemes will serve to counterbalance the proliferation of multiple pots whether by simply supporting a large number of employers or making consolidation at a member level much more streamlined. We appreciate this isn't always as easy as it sounds.

We believe the relatively narrow focus on costs remains problematic. However, in the experience of PASA members, those responsible for making scheme and provider selection are becoming more sophisticated. Selection, whilst driven by cost, is increasingly taking account of other factors which impact member outcomes.

More can be done to encourage this trend. Part of the challenge for those selecting a pension provider is gaining access to data which allows them to benchmark providers against each other. Clearly defined, industry-standard benchmarks are poorly defined and comparable data isn't readily available (see also our response to Question 3). The only truly tangible, comparable metrics available to a selection committee are price and investment performance. It's no surprise therefore these are the primary areas of attention when making a selection and the basis on which many restricting decisions are made. While these measures clearly have an impact upon member outcomes, they are by no means the only factors which do so.

An agreed industry definition of additional metrics would allow selection boards, employers, advisers and trustees to benchmark providers and schemes confidently and more comprehensively. These metrics should focus on outcomes which offer a sense of the scheme's effectiveness and the impact it's having on the financial health of its members. For example, the ability to track standards of governance, engagement levels of members and retirement choices of members can be a strong lead-indicator of outcomes. The extent to which members consolidate, seek advice at retirement, maintain up-to-date beneficiary nominations, monitor selected retirement ages, maximise pension contributions and select income-generating products at the point of vesting, can all be tracked and compared consistently across the market.

With a focus on these supplementary metrics, and supply data to support the comparisons, there could be a shift of emphasis away from a purely cost-driven assessment. Fewer but larger schemes make this kind of benchmarking more practicable and serves to increase accountability within the market.

Question 8:

How can government, regulators and industry incentivise scheme consolidation?

One way the government could encourage consolidation is through increasing the level and type of governance imposed on single trust schemes. It could impose such a high bar it becomes unworkable and unattractive for single trusts to continue to comply.

However, is this the outcome the government is really looking for? We believe there are a large proportion of medium to larger arrangements which are well run and should not need to consolidate. From our perspective, we believe government focus should be on:

- Ensuring the poorly run schemes are consolidated
- Not leaving those smaller schemes behind (which probably need help first)

We don't ultimately believe incentives are needed, or would be beneficial.

Question 9:

Is there anything else, not covered in the other questions, that the government should consider?

No further response.

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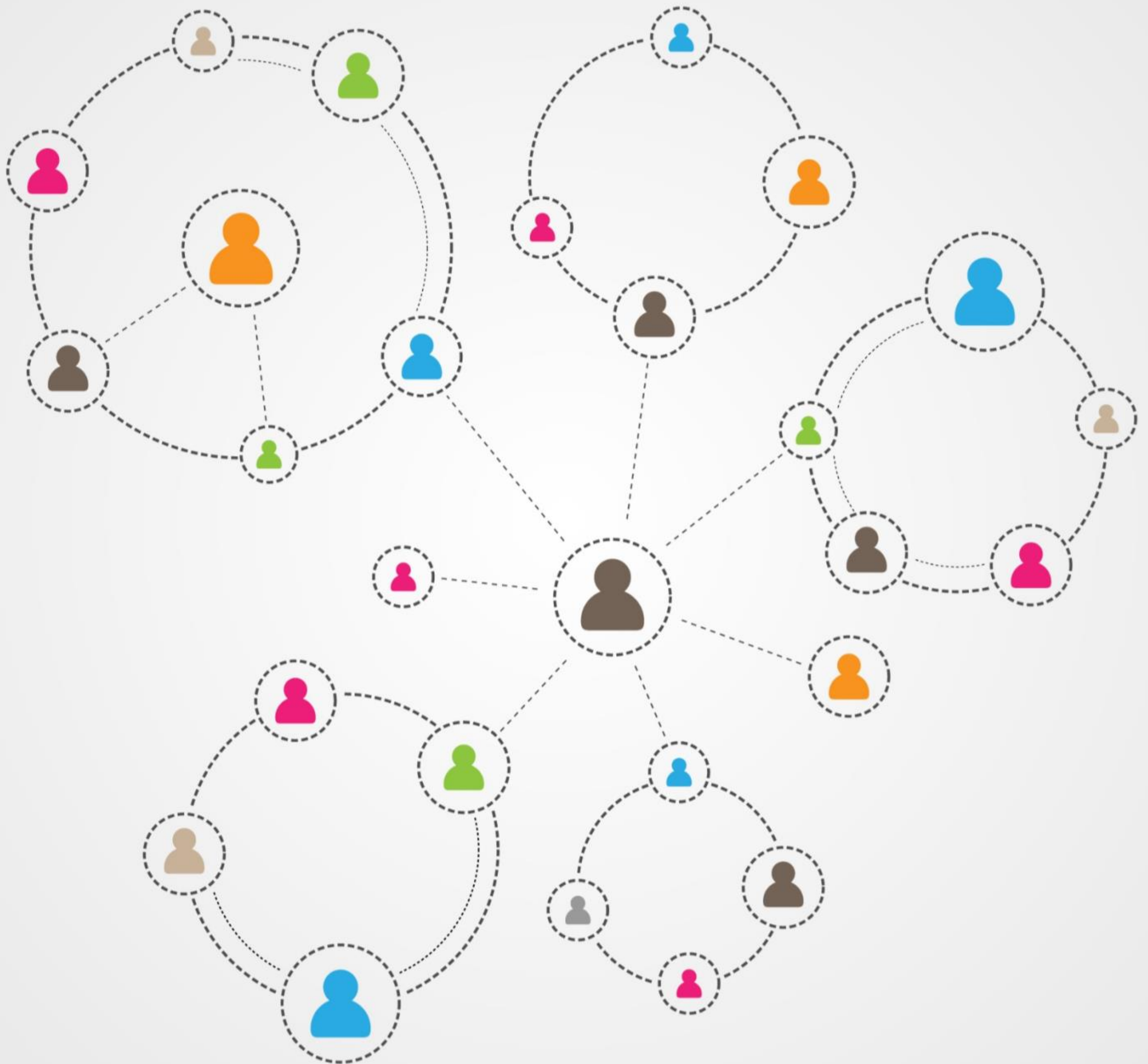

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