Summary
- Concerns over an auto-enrolment capacity crunch have not come to pass.
- It can cost a provider money to process small contributions, therefore relying on cross-subsidies from larger contributions to make doing so worthwhile.
- Smaller pots can be time-intensive for schemes to administer.
- A number of small master trusts unable to make contribution charges cost-effective through cross-subsidies have had to exit the market.
- The issue of administering small contributions is helped by the upcoming pensions dashboard, which should encourage members to voluntarily consolidate small pots.

Sweating the small stuff

Fears of an auto-enrolment capacity crunch have not materialised to date, but a wave of small value contributions have exercised minds in trust-based schemes

Along with the millennium bug, the Mayan calendar signalling the end of civilization in 2012, and the planet reaching peak oil in the 1990s, the auto-enrolment capacity crunch could soon be shelved in history's predictions-that-never-quite-came-true file.

With the smallest employers now enrolling their staff, there appears to be space for everyone, whether that be in a contract or trust-based arrangement. Nest has played a large part in allaying fears that potential savers would have the door closed on them, as have some master trusts, who have voluntarily chosen to accept every man, dog and investment risk profile.

Nevertheless, such openness does not come without its issues. The reason some providers have turned their backs on new savers is simple. Most of them can only afford the smallest of contributions. And for many DC trust-based schemes small value pots add up to one thing. A big headache.

Put simply, the maths doesn't add up, says independent trustee provider PTL managing director Richard Butcher. Take someone on average earnings, he says. Deduct the auto-enrolment minimum contribution, and then apply the charge cap. The result is that a scheme only recovers pennies from that individual.

He was recently told by one large-scale administrator that it costs about £157 a year to administer a pot for one member.

"So if you can recover pennies but you're spending £157, you can see that there's a mismatch here. It's not economically sensible," says Butcher.

"The reason it can work is because while there may be a whole bunch of people who are paying the auto-enrolment minimum who are on national average earning and therefore creating a cost drain on the provider, there are also a large number of people who are contributing far more than £157 a year. So this only works because there is cross-subsidy.

"That's something we have to grapple with as IGC members and as trustees – is there a reasonable distribution of value in the cross-subsidy?"

Time and money

Another cost factor that is aggravated by small pots is the general pension scheme levy.

Head of benefit solutions at Ascot Lloyd, which has its own master trust, Brian Smyth, explains that the levy is a significant charge on a DC scheme. As it cannot come out of members' funds, it is a cost to running the scheme that could become an even heavier burden in the near future.

"I can see a point where the larger master trusts – with Nest being a good example – end up having thousands and thousands of deferred members with low savings and paying a levy of £1 or £2 per member. They've got to make that money up out of their overall costing structure."

Small pots can put a further strain on finances by taking up a lot of administrative time. Smyth says that

larger companies within sectors such as retail usually have a number of deferred members with small funds, which can become quite difficult to manage.

"We had a trustee meeting the other week for one scheme and were trying to contact someone who is over 55 so that they can claim their very small amount of savings in cash and we can't get in touch with them."

Headaches of this sort could be alleviated, says The Pensions Administration Standards Association (PASA) chair Margaret Snowdon through better economies of scale in administration and rolling out automation.

"With full automation, many small contributions can be handled more efficiently. Unfortunately the market is not efficient yet. *[And]* efficiency takes investment.

"Economy of scale is vital, but without efficient automated processes and controls, even large schemes and providers will struggle to make money."

Shrinking pool

A number of small DC master trusts, unable to cross-subsidy, achieve economies of scale or properly automate systems, have already had to exit the market.

"It will never be economic to run small, low-value contribution schemes as many small trusts have found to their cost," says Snowdon.

"Many set up with a plan to reach scale, but it takes many years to break even and recoup the costs of set up. Ironically, the bigger the number of providers, the less scale for all but the most successful."

Butcher agrees, saying that economy of scale is impossible with the lamost 90 DC master trusts that are currently operational in the UK. In his view it is the master trusts with a long-term vision who will survive.

"If you talk to insurers, their model suggests that they are not going to make an operating profit for at least 10 years," he says.

"You've then got to recoup your losses from the past 10 years. So these things don't turn a proper profit for 15 to 20 years. Any provider has got to be able to survive that time scale and that's quite demanding. That's what's really driving consolidation.

"But if you underestimated the extent of your small pot problem, then that's going to push back your period to 20, 25 years."

Smyth reveals that Ascot Lloyd has been approached by another master trust looking to leave the market and expects to see others follow suit. Many master trusts that are struggling to stay afloat are also finding their governance standards affected, he says. The Pensions Regulator has already clearly aired its concerns over stewardship and master trusts unable to invest in improving governance are left with little choice but to find an exit route.

The need to meet increasingly-onerous governance standards is also affecting standalone DC trusts. Smyth was at another recent trustee meeting for a company that employs in excess of 1,000 people and has always had its own trust-based DC scheme. It is now seriously considering shifting its members into a master trust because of the requirements and the pressure on its trustees.

Further consolidation of small standalone DC schemes is inevitable, says Snowdon. However, she warns, the pensions industry needs to ensure that members do not pay the costs of exit by providers who find they cannot make ends meet.

The dashboard – a solution?

In order to put a stop to the small pot dilemma, policymakers have toyed with two mainstream solutions in recent years.

The first of these, pot follows member, suffered an ignominious death in 2015 following the last General Election, after being championed tirelessly by then Pensions Minister Steve Webb and the coalition government. With cost savings at the top of the list in every ministerial portfolio, the government judged that the significant expense of pot follows member would rapidly reduce any overall economic value.

The second, the pensions dashboard, looks set for a life beyond the planning stage.

"The regulatory and legislative hope is that if workers see all their savings in one place, then they will start to voluntarily consolidate them," says Butcher.

"And if they start to consolidate them, then you reduce the impact of small pots."

The obstacles in the way of a successful dashboard remain significant, however.

Redington head of DC Lydia Fearn says that at present administrators and providers remain in silos, sharing little. From a dashboard perspective, that needs to change, she warns.

"Blockchaining could be a way of underpinning systems driven to the dashboard, but there are a lot of legacy issues in the industry and it's not easy for it to take on these new technologies; plus they're very expensive," she says.

"So if we want to do more to have the members see what they've got, then we'll have to be more collaborative."

Another piece of the puzzle involves protecting DC savers from the growing number of scams that have arisen since pension freedoms.

Fearn says that with a saver's information segregated from every other scheme member, and checks and balances in place to ensure security, allowing easy access to pension data is getting harder.

"As the industry grapples to try and prevent scams, in a way it puts a barrier against giving members the information they need to make future decisions."

Add to the mix hesitation over contribution auto-escalation, and a fear over how members will react to higher savings, and it's clear that the small pot problem will continue to provide trustees with a headache for some time yet.

Written by Marek Handzel, a freelance journalist