Summary
• The number of DC schemes has decreased by just 3 per cent over the past year. There are 32,000 small DC schemes in existence. Of these, 23,000 are relevant small schemes, leaving around 10,000 single employer trust-based schemes.
• TPR will want these schemes to consolidate to improve economies of scale and governance.
• Moving into a master trust is the recommended method of consolidation.
• Consolidation may have slowed due to employers and trustees waiting for the results of the Pensions Act 2017, the DC-DC transfer consultation and the expected consolidation of the master trust market.
• Absent trustees and unwilling providers/advisers may also slow consolidation.
• The slowdown is expected to be just a 'blip' before consolidation continues in earnest.

Pressing pause

Following TPR's findings that the number of DC schemes in the UK declined by only 3 per cent last year, Laura Blows finds out what's behind this slowdown in consolidation

'Consolidation' – surely the central theme of a movie about the current UK pensions industry, if one ever were to be made – had been playing along nicely until recently. The rapid take up of master trusts for DC schemes, the idea of superfunds for DB, major providers merging; all underpinned by the concept of consolidation.

However, 'consolidation' is currently being watched in 'slow play' mode.

Setting the scene

According to the The Pensions Regulator (TPR) annual *DC Trust* report, as of 31 December 2016 there were still 34,500 trust-based DC schemes in the UK, 32,000 of them micro schemes (fewer than 12 members). These figures represent a decline of just 3 per cent, compared to the number of trust-based DC schemes the year before.

Speaking in January, at the time of TPR's *DC Trust* report launch, the regulator's executive director for regulatory policy Andrew Warwick-Thompson said: "Our concerns are rising about the fragmentation of DC provision and the persistence of a tail of sub-scale schemes. In our opinion, these pose an unacceptable risk to consumer protection. The consolidation trend we have observed and welcomed in previous years has slowed."

Over 32,000 may sound like a lot of small DC schemes, but 72 per cent of these, 23,000, are relevant small schemes, formerly known as small, self-administered schemes (SSAS) and executive pension plans (EPPs).

Relevant small schemes have no more than 11 members, which are usually the directors of the sponsoring company, with all members appointed as trustees of the scheme and decisions made by unanimous agreement. They are subject to fewer regulations than other occupational DC schemes, as the members are deemed to be investing the funds for themselves.

These schemes are running as intended and therefore are not what comes to mind when concerns are raised about the large number of small DC schemes *[Warwick-Thompson's recent comment that SSAS should be banned to protect scams is another matter].*

No, it is the approximately 10,000 schemes that are not relevant small schemes that the regulator is worried about.

These tend to be single employer, small, trust-based DC schemes. These small, single-employer DC schemes will be run with a TPA or a GPP dealing with the administration and a governance board or trust 'wrapped' around the whole thing, Salvus Master Trust managing director Graham Peacock says.

For the most part, these will be legacy schemes. Many of these schemes became paid up because of their unsuitability for auto-enrolment, and as they have no ongoing contributions, will be subject to higher charges than modern schemes, ITM executive chairman Duncan Howorth warns.

According to PTL director Alison Bostock, the large number of small DC schemes is a concern "because many are neglected, costly for members and there is no effective governance – we know from TPR that some are not even completing a scheme return".

Conflict

These schemes are likely to be causing concern for the regulator for a number of reasons. The regulator may wish the number of schemes to decline to a more manageable number for its own workload, Peacock says, but its primary focus is ensuring positive member outcomes.

The regulator recently refined its priorities down to eight, from 10, as a result of focusing on five risk areas. One of these risks is poor outcomes for members and sponsors of smaller DC (and DB) schemes that cannot benefit from economies of scale.

Of course, this is not the case with all schemes. As Bostock says, some of these small DC schemes will have valuable guarantees, usually relating to old style with-profits contracts or sometimes on annuity rates, which would be lost on transfer/consolidation, so it would be very hard to tell if it would be in the members' best interests to take them out of these old-fashioned schemes and put them in a modern scheme with lower charges.

"I have seen some of these where, despite high charges and low annual investment returns, the overall effect of guarantees should result in good member outcome in retirement," she explains.

Rising action

But overall, it seems the adage of 'bigger is better' is ringing true.

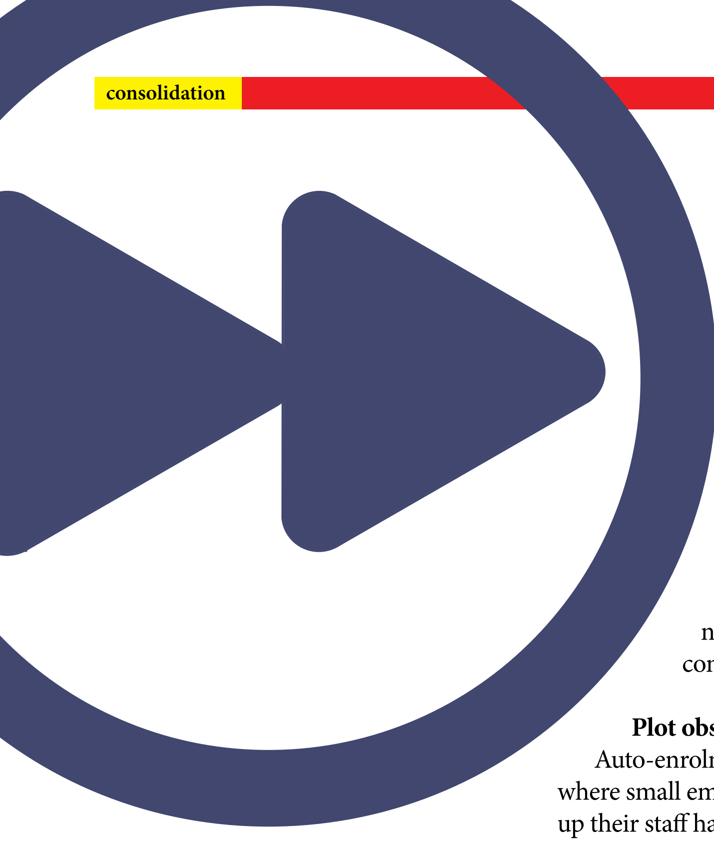
"DC is almost needlessly complex," Barnett Waddingham head of workplace wealth Mark Futcher says, and because of that level of complexity they are expensive to run. "And unless you have got significant scale, in terms of administration, you can't run those processes effectively. On the investment side, the more assets you have, the lower charges you get."

So, it seems clear that small schemes do need to consolidate. However, there is more than one way this can occur. For instance, Futcher does not believe the master trust method is the only way to consolidate the DC market.

"If you think about contract-based providers such as L&G and Aviva, they have massive scale; they have millions of records and run billions of assets. It doesn't matter what the legal framework is, whether contract based or master trust, the infrastructure in which the DC scheme sits needs to have scale. So you could have a relatively niche master trusts leveraged off the back of a big administrator, therefore bringing scale to that small master trust," he explains.

Group personal pensions (GPPs) run by an insurer is an option, but when the need for DC consolidation is discussed in the industry, the conversation invariably turns to master trusts.

"Look at the slating the GPP marketplace has taken over the past 20 years – commissions and active member discounts gone, consultancy charging banned, exit penalties up to the dizzying heights of 40 per cent banned and a 1 per cent cap put in place – so even the long-standing insurance companies are launching their own master trust propositions and are thinking that master trusts are the solution. So don't take my word for it, follow the direction of the big



insurers," Peacock says.

But it is not just the issues with GPPs that are driving the flood to master trust; it has plenty of its own benefits to recommend the structure to employers.

"When you compare a multi-employer solution, such as our own, or The People's Pension (TPP), or any of the well-governed master trusts, the scale of the governance standards, the administrative efficiencies and ultimately the value for members is going to be far better. The default funds of even the large single-employer DC schemes pale into insignificance when you compare it to the size of some master trusts' assets, so it can drive the costs of investing down," Peacock explains.

The Pensions Regulator's focus is certainly in the direction of master trusts, having been assigned new powers in order to oversee these schemes. In April its planned budget for 2017-18 was increased by £3.5 million in order to implement the master trust authorisation regime.

Speaking at the time of the *DC Trust* launch, Warwick-Thompson said: "Through the introduction and implementation of the new authorisation and supervision regimes for master trusts we will seek to create a secure, scalable and value for money cornerstone of the multi-employer DC savings market."

So with the benefits of – and regulatory focus on – master trusts, why aren't the number of schemes moving across increasing? Why instead is there a recent slowdown in the number of DC schemes consolidating?

Plot obstacles

Auto-enrolment reaching the stage where small employers are now signing up their staff has played a part in the slowdown of DC schemes' reduction, Futcher says.

When the larger companies were auto-enrolling, they were closing their previous, unsuitable-for-auto-enrolment schemes, he explains, but many of the smaller companies now auto-enrolling may not have had any previous pension provision, so are opening new schemes. However, TPR has expressed concern that of the 750 schemes currently being used for auto-enrolment (an increase from 490 the previous year), 360 fall into the 'micro scheme' category.

Auto-enrolment may be factor, but it does not account for the many legacy schemes failing to consolidate. Instead, it is thought that those managing these schemes may be looking for upcoming developments before deciding to move.

The Pensions Scheme Act 2017 is definitely one to watch out for, as the industry waits to see what actual regulatory changes emerge in practice from this.

The Act is set to increase standards and sustainability of master trust schemes. It requires master trusts to demonstrate that individuals involved in the master trust are fit and proper, that the scheme is financially sustainable, that the founder can meet certain requirements, that governance and administration systems are run effectively, and that it has a reliable continuity strategy.

Master trusts may be de rigueur from the powers above, but the master trust sector itself is expected to consolidate. There are currently 87 master trusts, which is generally agreed to be too many, so the larger master trusts are expected to soon incorporate the smaller ones.

According to Peacock, there will be a maximum of 20 master trusts by 2018. Therefore it is understandable that trustees and sponsors would wait and see which master trusts go the distance before transferring their scheme.

They may also be waiting for the results of the Department for Work and Pensions (DWP) bulk transfer consultation, which closed a few months ago. This explored making it easier for schemes to carry out DC bulk transfers without member consent.

The DWP said the aim of the consultation was to "reduce unnecessary burdens whilst ensuring members are adequately protected".

Under current law, schemes are able to make a bulk transfer of members' pensions without their permission, providing they meet certain conditions.

"These transfers need a certificate from an actuary," Bostock explains, "under guidance and regulations that were designed for defined benefit schemes. These regulations are under consultation, so perhaps advisers are suggesting that employers and trustees hold off until we know if the process will be made easier."

However, even once the results of these legislative changes are up and running, it seems unlikely that all 10,000-odd schemes are going to instantly rush into available master trusts. What other barriers may be preventing consolidation?

Inertia and lack of understanding – two things that the individual saver is often accused of – may also apply to the trustees of these schemes. "In some cases they are perhaps not even aware they are appointed as trustees," Bostock says, "because it was common for the employer to be appointed as sole corporate trustee to a bundled scheme provided by an insurer and the original adviser may no longer be in place."

Also, employers may not be willing to pay the advisory and professional trustee fees needed to guide the transition, and providers of closed bundled schemes may be reluctant to push for action because older and higher-charging structures apply to these schemes, she adds.

Howorth agrees that the blockage that exists with 'absent trustees' is significant and needs resolving, as does the 'who pays for this' question.

"I don't see advisers being the solution to consolidation of these schemes – it's going to need a more holistic, structured approach to the problem – a scheme-by-scheme approach will take forever," he explains.

Third act resolution

With these additional barriers to consolidation in place, the regulators may need to give those managing schemes a 'nudge' in the right direction.

According to Howorth, TPR could and should use its powers to appoint independent trustees to replace lost trustees and carry out reviews/wind ups.

"The FCA and TPR could require insurers to review their older DC pension trusts products, like the IPB review for contract-based schemes," Bostock says, "as it seems that relying on trustees to assess value for money and take any action required has not worked."

Employee benefits consultancies have a role to play too. They understand the reasons for consolidation and can explain it to their clients – plus some may have the added incentive of their own master trusts products to want to encourage growth in this sector, Peacock suggests.

Another factor that may drive consolidation, Pensions and Lifetime Savings Association (PLSA) policy lead for defined constribution Tim Gosling states, is that should the charge cap on qualifying default funds be reduced further following the 2017 review, "we would anticipate a sharp increase in the rate of consolidation among small- and medium-sized schemes".

The upcoming pensions dashboards may also have a role to play, Howorth notes, as it may encourage members to transfer into a new or existing scheme into which they are contributing

Bringing all this together, massive consolidation of DC schemes seems inevitable.

"If all the changes occur, with regards to scheme supervision and authorisation, as expected, it will become almost impossible for these small schemes to continue," Peacock says. "The current slowdown in consolidation is just a short-term pause for the Pensions Act, the DC-DC transfer guidance to complete, and for master trusts to consolidate themselves."

So a pause may be the case for now, but it's expected that the industry will soon be fast-forwarding to reach the dramatic climax of the consolidation story.

Written by Laura Blows

What about DB?

It is not just small DC schemes that have come under fire lately. Concerns have also been growing about the number of small DB schemes in existence. There are currently 6,000 DB schemes with approximately 11 million members, according to the government's *Security and Sustainability in Defined Benefit Pension Schemes* green paper. However, 10 per cent of these members are spread across 81 per cent of DB schemes.

The PLSA's DB Taskforce *[see p53]* finds that while any level of consolidation would provide cost savings and reduce risk, be it through shared services, asset pooling or single governance, it is a full merger into a superfund that it says would most improve security for savers – with some potentially seeing the risk of their scheme failing falling from 65 per cent to under 10 per cent.

"We believe the superfunds have the potential to offer great benefits to members, employers, the regulator, the industry and the economy. Members get a better chance of more pensions benefits being paid. Employers get a lower-cost alternative to buyout. The regulator gets a sector with better managed risks. The economy benefits from improved investment by superfunds and employers are freed from onerous DB burdens," DB Taskforce chair Ashok Gupta said in March.

A recent Pensions Management Institute survey found just over half of its members would support mandatory consolidation of DB schemes in some circumstances.

However, in February, the government declared itself against designing and running a DB superfund through an arms-length body, but it is open to supporting the industry if it wishes to implement voluntary consolidation.