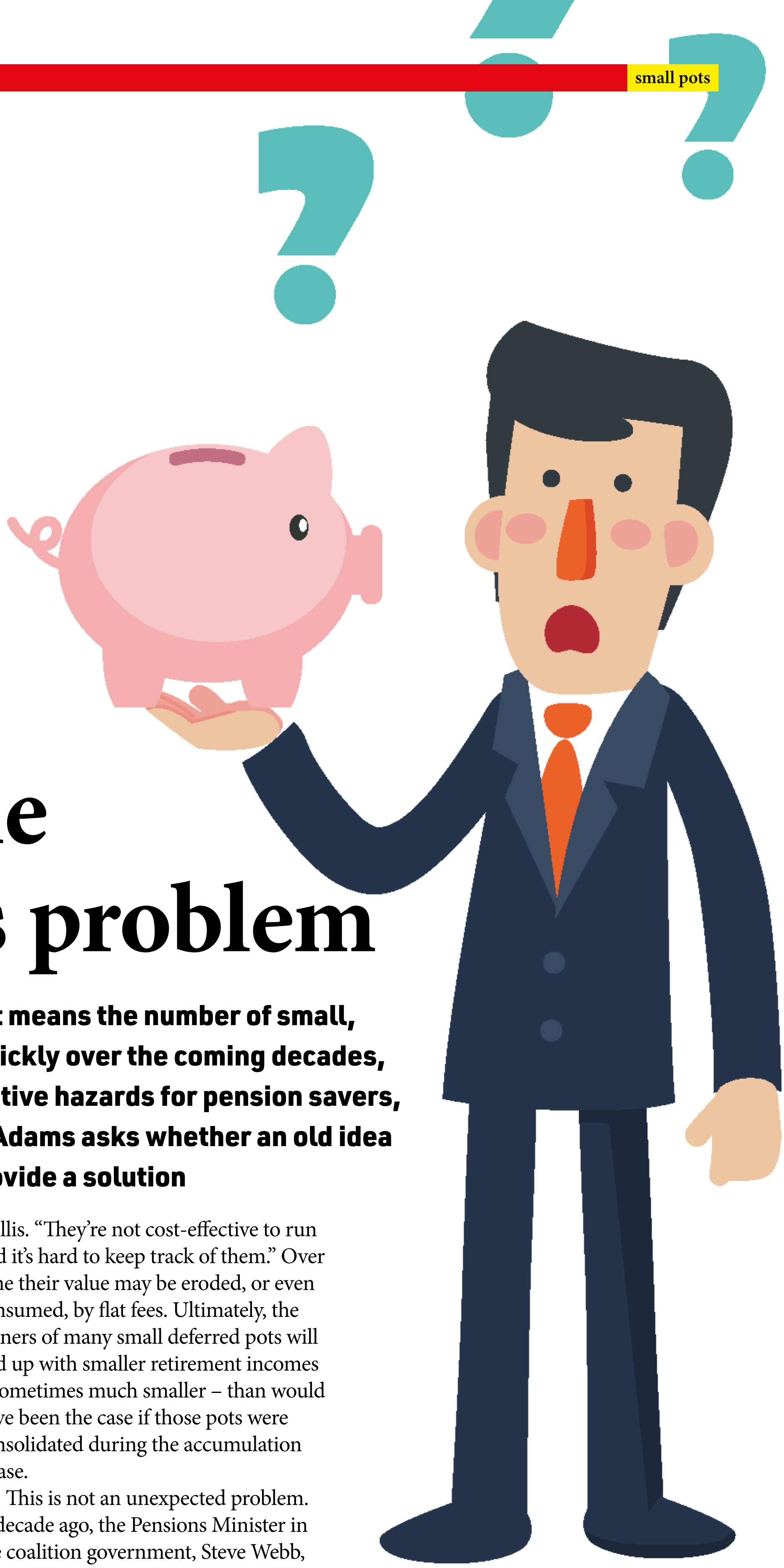

Summary
• The number of small, deferred DC pots has been increasing rapidly since the introduction of auto-enrolment, creating administrative problems and costs for members, providers and employers.
• Pot follows member is once again under discussion, but alternatives and/or complementary elements of a solution could include a default consolidator system and member exchange.
• There are mixed views within the pensions industry about the pros and cons of these systems.
• Further consultation and data gathering will be needed to determine the design of a small pots consolidation regime. With new legislation also likely to be necessary it is likely that it will be some years before the phased roll out of a consolidation solution for small, deferred pots.

Solving the small pots problem

The success of auto-enrolment means the number of small, deferred DC pots will multiply quickly over the coming decades, creating financial and administrative hazards for pension savers, providers and employers. David Adams asks whether an old idea – pot follows member – might provide a solution

Small is not beautiful when it comes to deferred DC pension pots. About three million deferred pots contain £100 or less and 10.5 million hold less than £1,000, according to the Pensions Policy Institute (PPI). The number of small deferred pots grew rapidly during the past decade, as auto-enrolment led to more people creating then abandoning pots when changing jobs.

"Small pots don't help anyone," says Barnett Waddingham partner, Martin Willis. "They're not cost-effective to run and it's hard to keep track of them." Over time their value may be eroded, or even consumed, by flat fees. Ultimately, the owners of many small deferred pots will end up with smaller retirement incomes – sometimes much smaller – than would have been the case if those pots were consolidated during the accumulation phase.

This is not an unexpected problem. A decade ago, the Pensions Minister in the coalition government, Steve Webb,

was among those advocating for the use of pot follows member (PFM), a system in which deferred pension pots would move with people as they moved to a new employer and pension. PFM transfers would have to be into pension arrangements that offered equivalent or better benefits; and individuals would have the right to opt of the transfer if they wished.

In 2018, one of Webb's successors, Guy Opperman, ruled out using PFM. But today the idea is once again being evaluated by the Department for Work and Pensions (DWP). Between January and March 2023, it ran a call for evidence consultation on possible solutions to the small, deferred pots problem, including PFM and/or some form of default consolidator system, in which small, deferred pots would be transferred automatically into multiple or possibly a single vehicle. It is also considering use of a member exchange system, in which the provider of a new active pot would look for deferred pots held for its new member by other providers, with a view to consolidation.

The call for evidence builds on the work of the Small Pots Cross Industry Coordination Group, led by the Association of British Insurers (ABI) and the Pensions and Lifetime Savings Association (PLSA). The group's June 2022 report recommended that the government consider each of these options.

"All have pros and cons," says PLSA deputy director, Joe Dabrowski. "We think a combination may be needed."

Webb, now a partner at LCP, believes the case for consolidation "is stronger now than it was 10 years ago", in part because a system would be able to use some of the infrastructure that will run pensions dashboards.

Possible drawbacks

But there are other questions that would need to be answered. One would be how to define a small pot. The DWP call for evidence sought feedback on four possible limits: Under £1,000, £2,500, £5,000 or £10,000. It also asked whether the smallest pots, containing less than £100, should be excluded from the system and refunded to the deferred members instead.

PFM would also be complicated by factors including people working in multiple jobs at the same time, or those who build up more than one pot at the same provider with different employers at different times. Regarding the latter, DWP research using data from 11 auto-enrolment providers suggests that consolidating multiple pots held by the same provider for the same person could consolidate over a million small, deferred pots.

But every transfer of a deferred pot through PFM would also cause what Willis calls "value seepage", when assets are converted into cash so are not taking on any risk. Pensions Policy Institute head of policy research, Daniela Silcock, highlights the cost of each transfer to members. "There's an assumption that employees bear most of the cost, for transfer and administration fees," she says. "We need to invest in infrastructure

that will make transfers cheap."

There is also the risk that a transfer takes a pot into a lower quality scheme. "It's a good idea where individuals are moving between well-regulated, well-run products, but I get more nervous where people are moving to products that perhaps aren't as well managed, or where people are currently in a good pension with guarantees," says Hymans Robertson partner, Chris Noon.

For Broadstone head of policy David Brooks, the problem with PFM is the cost to employers. "Given their existing responsibilities contributing to members' pensions and implementing auto-enrolment we do not believe enforcing pot follows member would be the optimal use of their time or money," he says. "PFM might be an effective method for current savers and their most recent fund, but we believe there are logistical challenges around legacy pots."

Another potential problem is that PFM might undermine the ability of master trusts and large pension funds to invest in long-term, illiquid assets such as infrastructure projects.

"In a PFM environment you need to keep a degree of liquidity in your fund, so you can produce transfer payments as employees move," explains People's Partnership group director of policy and external affairs, Philip Brown. "That could have a detrimental impact on your ability to put a proportion of your assets into long-term illiquid assets."

Other options

People's Partnership favours a default consolidator model, under which deferred small pots would be transferred automatically into an approved consolidator. If there were multiple consolidators members would be able to choose which to use, with those who do not make an active choice having their pot moved into one of them by default.

"The case for consolidation is stronger now than it was 10 years ago"

Such a scheme could offer similar simplicity and efficiency to individuals, providers and employers; and enable investment in illiquid assets. Potential drawbacks include a need for providers and employers to identify and work with an individual's previously nominated consolidator pot; and the incentive for providers to market their services, possibly affecting fees for members.

But Brown sees a multiple consolidator model as a much better option than one based on a single default consolidator model, which would have "market distorting" implications.

"If all your money is going to end up inside the same scheme then why wouldn't you just choose to put all your money into *[that scheme]* anyway – and then eventually you've consolidated the entire market into one scheme," he explains.

There are other options. In March 2023, Anthony Browne MP introduced a Ten Minute Rule bill in parliament making the case for another option: a Lifetime Provider model, in which individuals choose a single provider into which all their own and each of their employers' pension contributions could be consolidated.

Some industry figures welcomed the bill (which will not become law), but Dabrowski was less impressed.

"It alters the philosophy behind auto-enrolment and *[loses]* the benefits of inertia," he says. "We would also be worried by breaking the link with the employer, which helps employers provide better pensions. It would also be difficult to administer if people were moving around a lot: Often pensions are wrapped up with a lot of other benefits."

Willis warns that of the various models under consideration the lifetime provider idea may be "least easy to implement"; and that it could put people at risk of choosing arrangements that did not meet value for money criteria.

Whichever system is used, it would need to be phased in slowly. Webb suggests starting with new deferred pots, then extending the system to other auto-enrolment pots, then to other deferred pots, where appropriate. But he expects development and implementation to take a long time, in part because new primary legislation would almost certainly be needed. "There would be further consultation on the details, then you'd need a few years to set it all up," he says. "If we get going before 2030 we'll be doing well."

He puts in one last word in favour of PFM, pointing out that consumer research undertaken so far suggests that ordinary savers may be better able to understand and use PFM than a default consolidator system – but he thinks the latter would be useful too: "As long as we do either of them I'd be pleased."

Written by David Adams, a freelance journalist