Stronger together

Summary
• The increasing number of small, deferred pension pots is a growing issue for the industry, members and regulators alike.
• Despite the belief that reducing the quantity of small pots will be widely positive, several concerns and challenges remain.
• Working groups have been formulating potential solutions to the issue and trying to strike the right balance between costs and benefits.
• Some forthcoming transfer regulations could pose a challenge to the initiative's progress, while dashboards could help match members to pots.

At the latest PLSA Annual Conference, one of the key items on the agenda was addressing the proliferation of small, deferred pension pots. Jack Gray provides a round-up of the session, looking at the scale of the issue, the work done by the Small Pots Cross-Industry Co-ordination Group so far, and the potential solutions

Following the Pensions and Lifetime Savings Association's (PLSA) announcement that in-person events will resume next year, pension professionals from around the UK and beyond gathered round their computer screens for potentially the final time for a PSLA Annual Conference.

One of the most popular and topical sessions was on the rise of small, deferred pension pots. Hosted by Capital Cranfield professional trustee and Small Pots Cross-Industry Co-ordination Group chair, Andy Cheseldine, the session looked at the scale of the issue, the work that has been done, potential challenges and possible solutions.

Cheseldine began by describing the current state of affairs: "It is a major issue for the UK economy as well as pensions. There are over three million members of defined contribution (DC) pensions invested in default funds who have less than £100 in their pot.

"That is a staggering number, and it's not doing the industry or the members any good at all. That number grows to 10.5 million if you take pots of £1,000 or less. If we think about going forward to 2035, the Pensions Policy Institute (PPI) estimates that there will be over 27 million pots of less than £2,000. We need to do something."

The first panellist to speak was PLSA head of DC, master trusts and lifetime savings, Alyshia Harrington-Clark, who noted that increasing numbers of small pots was "a known issue" at the outset of the implementation of auto-enrolment, and work has continued "on and off" since then.

She warned that the issue was likely to get worse with reforms to auto-enrolment, scheduled for the mid-2020s, whereby the earnings trigger would be lowered and the minimum age will be reduced to 18.

"Small pots can also be a problem at decumulation because those with small pots have a tendency to cash in their pot rather than use it as sustainable income," Harrington-Clark continued.

"There is also an impact on schemes. At a system level there is likely to be excessive administration costs caused by the management of small pots. Reducing the costs and inefficiency in the system is likely to result in better outcomes for members.

"Small pots pose a particular problem for AE master trusts because they service a part of the market where small pots are more likely to build up."

Following on from this, Which? senior economist, Stephen McDonald, detailed the potential benefits of finding a solution to the small pots issue. He spoke of a "big systemic gain" that would benefit everyone in the industry. By reducing the number of small pots, it will take costs out of the system, he stated, which should "hopefully" lead to lower charges or the freeing up of money to invest in other things that will provide a better service to members.

"For individuals there are other gains. If you have pots scattered far and wide, there is a big cost there to try to and find them and access them, and some of that should be resolved by the dashboards," McDonald explained.

"Another clear benefit is simpler decision making. If you have fewer pots, and maybe larger pots too, it should make people's decumulation decisions that bit easier."

However, McDonald warned that there was a risk that certain individuals could be worse off because the returns they get in one scheme may not equal the returns in another scheme.

"The fundamental issue is that there is this gain to be had, but how do we do that when some individual might be made worse off? There is a balance to be struck there," he added.

"The big question is: who is there to make that decision about where that balance is? It's very difficult for an individual scheme to make that decision. That is why I think where we have got to is that there is a role for government here in intervening on that balance.

"There are a lot of factors to keep in mind. The size of the pot – if it's a very small pot the potential for harm there is quite small, but as the pot gets bigger different factors come into play. Potentially investment returns, distance to retirement and size of future contributions.

"It also depends on where these pots are going from: are they going from master trust to master trust? Are they trying to move across the contact and trust spaces? There are big challenges there and its possible we won't get one size fits all. Maybe the policy solution for pots under £250 might look different to pots once you get into the low thousands."

Another big challenge identified by McDonald was the lack of evidence on the size of the potential benefits to members. He noted that we do not know that the systemic gain will be and how much of that would be passed onto members.

Furthermore, he warned that we do not really know what the cost of accessing multiple small pots is and we "certainly" do not know much about the decision-making costs.

"The one thing we do know with certainty is the charges so, inevitably, that comes to the forefront when trying to make these decisions," he continued.

"What we need is a lot more evidence to really understand the benefits of this consolidation. We need to know who wins when and who loses when, and only with that information can we say to government: 'this is what should happen, this is the outcome we want to see, this is when it is worth it, this is when, actually, we can't have a system where every pot is consolidated and every member always gains out of every single one of those consolidations but, across the piece, these small losses might be worth living with because we get this systemic gain and members benefit overall.'"

Other potential consumer harms identified by McDonald were mis-matched pots, the potential loss of guaranteed benefits and scams risks, although he noted that none had caused "fundamental problems" and could all be solved "quite easily".

"You could resolve issues with guaranteed benefits by just not moving those pots, you can largely resolve the scams risk by having very tight processes, and the mis-matched pots – no one has the expectation that you will get 100 per cent accuracy with data, but as long as you have appropriate redress mechanisms in place for the small number of pots that are mis-matched then that shouldn't be as issue," he stated.

Association of British Insurers manager, long-term savings policy, Hetty Hughes, then covered the administrative challenges that may arise. She noted that any solution needs to be economically viable and that questions remained as to who would be liable for any mis-matched pots.

"We mapped out the current broad process for member-initiated transfers, which will be different depending on the level of automation the provider has," she continued.

"We identified some areas where efficiencies could be made. Unsurprisingly, any paper in the process increases cost and there was discussion as to how you could digitise communications and make it more prevalent across the market. There are some barriers to that: having accurate email addresses or phone numbers of savers isn't typical of the scheme

"The group felt that it was possible to have a triage process in place where the pots were identified and could go through a separate system to other transfers. That would mean that any errors that are flagged up in the process, the pots could be left where they are rather than any manual intervention."

There were also calls for some transfer regulations to have small pots carve outs, Hughes added, and the working group noted that forthcoming

regulations on the stronger nudge, scam red flags and changes to the normal minimum pension age would affect the cost of transfers.

"We started to look at the automatic transfer solutions that were on the table, namely pot follows member and default consolidators," Hughes explained.

"One thing that was really clear was that savers would likely be given an opt out of any process, but there was a feeling that this should be part of existing communications. It should be noted that up-front investment would be needed for any of these processes.

"I think there is broad consensus from the group that there would need to be compulsion for an industry-wide solution."

To help address the issue of small pots, Hughes said that both provider- and member-driven solutions would be needed to minimise member detriment, with the next steps expected to be finding which model to use for automatic transfer solutions.

She also called for automatic small pots transfers to aim for a high bar of accuracy, but warned that a balance would need to be struck.

"Too high a bar might mean there are too few transfers made, but too low a bar might mean that there are too many errors," she explained.

"There needs to be more research to find out what the 'right' error rate would be, and we need to learn more about schemes' data accuracy, which we should be able to after pensions dashboards."

Further investigation and development were needed on the 'find' mechanism for matching savers to their pots, she noted.

Concluding the session, Harrington-Clark spoke of key principles the PLSA believes should underpin all the work: "There should be no material detriment to the saver from being automatically transferred between DC schemes; transfers should be efficient for schemes, and simple and quick for scheme members; transfers shouldn't rely on active decisions by members to take place; and competition issues should be managed."

The Small Pots Cross-Industry Co-ordination Group will focus on the models throughout the autumn, she added, while the eventual solution should be a "combination of a solution designed to operate in the short term to reduce the stock of existing small pots", and a more ambitious solution designed to resolve the flow issue.

"That is probably over a longer term, something like a default consolidator or pot follows member, connection with dashboards, and there are lots of other things we've considered in light of the idea of these future models," she stated.

"It's clear that the two future models that should be prioritised are those default consolidators and pot follows member models. But there are a lot of other factors that have emerged through the work that might help us design things like default consolidators plus or minus or tweaks to those models to make them more effective."

Written by Jack Gray