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Addressing the challenge of small pots

The question of how to deal with the growing number of deferred small DC pots is not a new issue. The DWP previously legislated for a 'pot follows member' solution, although this was not brought into effect.

The impending arrival of pensions dashboards means that the focus on small pots has now moved from concern about members losing track of their pension savings to the costs incurred by trustees and providers in maintaining these entitlements.

The DWP has published a call for evidence on automatic consolidation options for dealing with the small pots problem, which runs until 27 March 2023.

Background

One of the results of automatic enrolment is that while more people are benefitting from pension saving than ever before, the number of deferred small pots has increased greatly.

Research published by the Pensions Policy Institute (PPI) suggested that in 2020 there was an estimated 8 million deferred pots and without intervention that number is likely to rise to 27 million by 2035 (within authorised master trusts alone). The PPI has also conducted research to suggest that the total value of lost pension pots has grown from £19.4 billion in 2018 to £26.6 billion in just four years.

This growth adds increased costs and inefficiency to the UK workplace pensions market and it has been estimated that the continued growth in the number of small pots by 2030 will likely result in wasted administration costs of around a third of a billion pounds every year.

Progress to date

Critics of work on small pots will, no doubt, highlight that this is hardly the first time the issue has been considered. After being consulted on extensively – and legislated on - by the coalition government a decade ago, the DWP then established the Small Pots Working Group in 2020 to examine the scale, nature, and impact, of deferred small pots and to build a consensus on the priority options to address their growth. The Working Group reported back in December 2020 and found that although opportunities for member-initiated consolidation should continue to be maximised, these would be unlikely to change the trend in the growth of deferred small pots without other action. It concluded that the pensions industry, working alongside government and regulators, should prioritise work on enabling automatic and automated large-scale low-cost transfers and consolidation for the automatic enrolment market.

Some months later, the Association of British Insurers and the Pensions and Lifetime Savings Association, jointly convened the Small Pots Cross-Industry Co-ordination Group to take forward analysis of the administrative challenges identified by the Working Group.

The Co-ordination Group agreed a set of working assumptions that covered the nature and value of small pots assumed to be within scope of any future consolidation model, whilst also setting out further evidential needs to build the case for a large-scale consolidation solution.

Problems caused by small pots

The work undertaken to date has highlighted the range of risks that deferred small pots present in terms of member outcomes. Inefficiencies in the system are passed onto members, with those with larger pension pots effectively being charged more to subsidise the lack of revenue generated by small pots. Members may also find that small pots are further eroded through charges.

Small pots can negatively impact on the way that members engage with their pension savings. Members may lose track of multiple pots over time, or be disincentivised or disengaged, by multiple small pots that do not contribute in a meaningful way to their prospective retirement income and add a layer of complexity to their pension saving.

For some pension providers, the inherent inefficiency in the current system may even threaten their longer-term financial sustainability with the administration costs involved for managing millions of deferred small pots outweighing the amount they receive through charges.

What constitutes a deferred small pot?

The call for evidence recognises that a key consideration for any large-scale consolidation solution is what the maximum value is below which a deferred pension pot should be considered eligible for automatic consolidation.

Setting the maximum value at too low a level may result in insufficient consolidation which will then fail to adequately remove cost from the system to ensure that members receive the value for money dividend.

Alternatively, if the size at which consolidation applies is set too high, members may be at risk of greater detriment as a result of their pots being moved into a single scheme which has differing and more costly charge structures or lower investment returns. There may also be a negative impact on schemes which begin to lose more profitable pots.

The DWP is looking for views on the most appropriate starting limit for automatic consolidation: £1,000, £2,500, £5,000, £10,000, or some other value?

Another consideration is whether there should be a minimum pot size for automatic consolidation, with ‘micro pots’ being excluded from a consolidation solution. The DWP asks questions about this, but is of the view that they should all be included.

A further key question is the point at which a pot should be considered ‘deferred’ and become eligible for consolidation. Several triggering events have previously been considered that could make a pot eligible for automatic consolidation and it was concluded no employer or member contributions being made within a prescribed period would be the most suitable trigger event for consolidation.

Automatic consolidation solutions being considered

The DWP is focusing its attention on two potential consolidation models: a default consolidator and a pot follows member solution (while recognising previous analysis that a ‘one-size-fit-all’ approach may not produce the best outcome, and a combination of models may be needed).

Both solutions could remove a considerable number of deferred small pots from current workplace pension schemes, ease the financial strains on pension providers through reduced administration costs which would enable them to provide greater value for money to their members, and require no active involvement from members. The call for evidence highlights other potential benefits and implications of each model (some of which are set out below).

In both cases, members would need to meet certain eligibility criteria and would have the right to opt-out if they wanted to.

Default consolidator

Under this model, deferred small pots would automatically transfer to a small pot consolidator.

There are a variety of a ways through which a member could be allocated to a consolidator scheme - either based on the consolidator being the scheme that a member is enrolled into when first automatically enrolled into a workplace pension, or a member could choose from a list of approved consolidators and where the member does not take the opportunity to make an active decision, they could be allocated to a consolidator from a carousel system.

There could also be a single default consolidator operating, either a private-section solution or a State-backed consolidator.

Potential benefits and implications

- Over time, consolidator schemes could generate scale to drive greater value for money and efficiencies for members, such as a greater opportunity to invest in more illiquid assets, whilst setting lower charges for their members.
- A single consolidator would reduce the complexity inherent in multiple pots and make it easier for members to engage with their overall pension wealth.
- Schemes would be able to transfer out deferred small pots which may improve the sustainability of smaller providers as they would no longer be managing unprofitable pots, with benefits being passed on to their remaining members.
- A robust authorisation regime would be required to ensure that schemes acting as a default consolidator are able to manage consolidation effectively and without risk to member interests.

Pot follows member

When an employee moves jobs their deferred pension pot in their former employer's scheme would automatically move with them to their new employer’s scheme.

Potential benefits and implications

- This approach should enable greater levels of consolidation to be achieved; however, there will be some situations where it may cause complications and a consequent increase in administrative burden, for example, the position of multiple job holders.
- As this solution makes a link to the active employer there may be situations where there is an increased burden on that employer, for example, in terms of handling more questions from employees about the way in which pension arrangements are working.
- There is a risk, dependent on the maximum pot value limit set, that members may end up reaching that limit relatively quickly and the pot becomes stuck in the system, resulting in the member still accumulating deferred pots – albeit at a greater value.
- There is likely to be minimal cost to taxpayers.

Other potential solutions

The DWP recognises that other models exist that could help combat the issue of deferred small pots, which wouldn't perhaps lead to the same level of consolidation but could still help to achieve its aims.

Member exchange

Pension providers could use a trusted third-party pseudonymised data service to conduct a regular exercise and identify 'matches,' where they hold a deferred small pot for a member and another provider has the same individual as a member making active contributions into another pot.

Pot for life for returning members

Pension schemes could combine the further pension savings of members for another period of service into a single pot, to prevent members from accumulating multiple pots within the same scheme.

Comment

While the DWP could certainly be accused of not resolving this issue as quickly as the industry would have liked (and the pot follows member solution is already on the statute books, but not brought into force) it is good to see the issue has not been forgotten about.

The number of deferred small pots is not going to fall away without action being taken and it seems clear that a member-based solution will not work on its own. Whether the default consolidator or pot follows member models, either individually or in combination, are the answer remains to be seen.

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