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# PPI

Policy options for tackling the growing number of deferred members with small pots



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- Taking a long-term perspective on policy outcomes on pensions and retirement income
- Encouraging dialogue and debate with multiple constituencies

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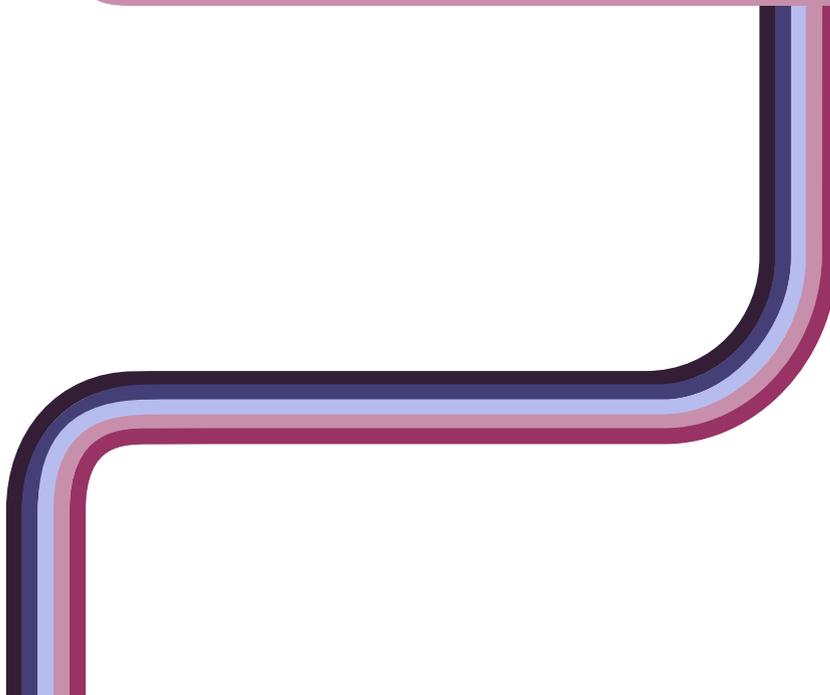
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# Executive Summary

This report explores the potential outcomes on the number of deferred pension pots, charges for members and costs for providers of a range of policy options. This summary covers the main points of the report and acts as the conclusion.

## **To effectively reduce the number of small, deferred pots, large scale policies will need to be introduced alongside more streamlined, uniform systems for payroll and pot transfers**

The number of deferred pension pots in the UK Defined Contribution (DC) master trust market is likely to rise from 8m in 2020 to around 27m in 2035. Member charges often erode small, deferred member pots over time and small pots can be uneconomic for providers to manage. Extra management costs may eventually be passed on to members through increased charges. Financial instability in master trust schemes, arising from too many small pots, could, in extreme circumstances result in trustees triggering an event to wind up the scheme.

## **Policies aimed at consolidating pots are likely to provide a better long-term solution than tackling charging structures**

Altering charging structures is unlikely to resolve the problems associated with small, deferred member pots, as charges either erode member pots or prevent schemes from breaking even on pot management, and deferred pots will not generally grow large enough to overcome these issues (unless they are re-joined by the member or transferred to consolidate with other pots).

If DC pension pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation is required. With all policies, there are trade-offs to consider. All policies have potential benefits and drawbacks, and the relative merits will be viewed differently by different stakeholders. Consideration by policymakers will need to involve all of the potential trade-offs associated with each model and how policy levers may mitigate potential negative outcomes.

## As all policies have potential benefits and drawbacks, a combination of policies may be helpful going forward

All of the policies explored in this report reduce the number of deferred pots, the charges that members pay, and the costs paid by providers, to some degree. However, the policies cannot be judged solely on their economic impact. All policies involve trade-offs and some present potential market difficulties such as giving particular schemes a competitive advantage or encouraging “cherry picking” of members who appear most profitable. Some policy models, such as the lifetime provider model, would involve significant restructuring of the regulatory framework governing pension schemes.

A policy model which combines aspects of several of these, including the use of dashboards, could help reduce small pots without giving undue advantage or disadvantage to any particular scheme or member. It is worth industry and policymakers reflecting on a model which highlights the potential benefits attached to the models discussed in this report but contains functionality which reduces the potential for disadvantages.

In order to successfully deliver a policy to reduce the number of small pots, a degree of consensus among consumer and employer representatives, industry, Government and regulators (all affected parties) will be necessary, and therefore all these groups should be included in the decision-making process.

This report considers the potential impact on small pots of the following policy options:

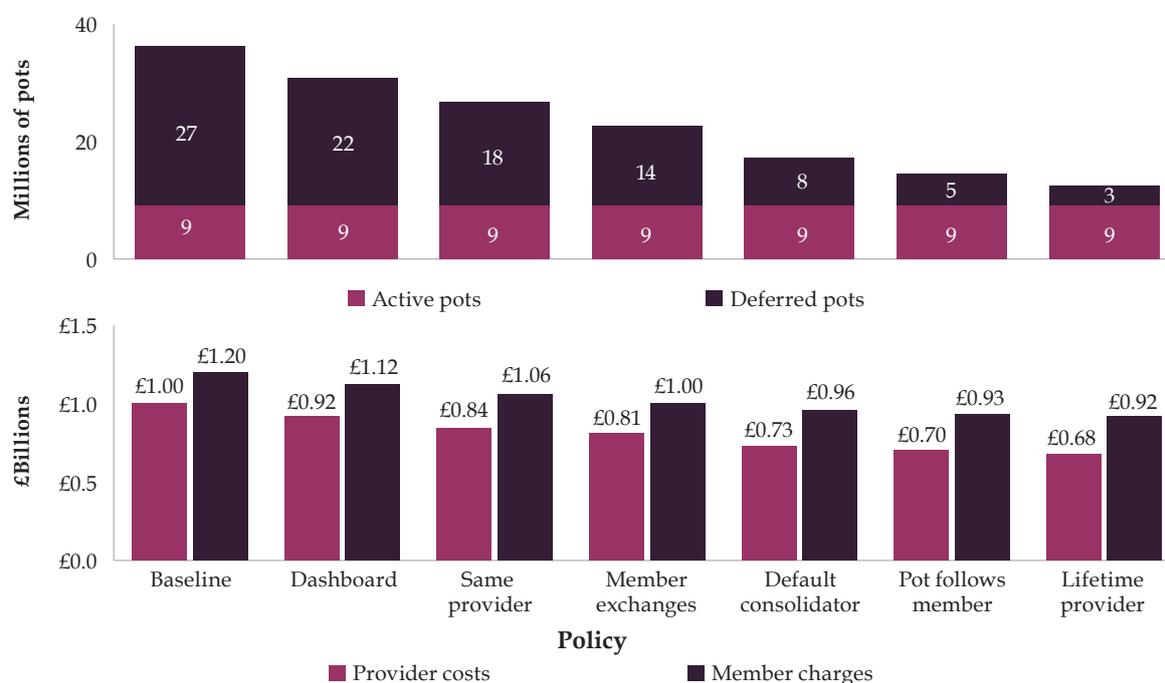
- **Dashboards:** platforms that allow members to view all pots with different providers in one place and could facilitate more consolidation (though this is not the sole intention of dashboards, which are designed to enable informed pension decision-making).
- **Same provider consolidation:** returning members are re-enrolled into their deferred pot.
- **Pot follows member:** pots move with members to new employer’s schemes.
- **Member exchange:** a form of pot follows member, which allows for the reassignment between schemes of all existing pots into the current active scheme.
- **Lifetime provider:** members remain with the same provider throughout their working life.
- **Default consolidator:** pots deferred for a year, transfer to a consolidator provider, with members being given an opportunity to opt out.

## Consolidator models reduce the number of deferred member pots, member charges and provider costs to varying degrees

All the policy models explored reduce the number of deferred member pots, the amount members pay in charges and the cost to providers of administering pots, with the lifetime provider and pot follows member models resulting in the most significant impact by 2035 (Chart Ex.1).

Chart Ex.1<sup>1</sup>**Consolidator models reduce the number of deferred member pots to varying degrees**

Number of active and deferred pots, aggregate member charges and aggregate provider costs in master trust universe by 2035 under different policy models



The key benefits members and providers derive from small pot consolidation is that member charges become more affordable as pot sizes grow, and provider costs are reduced as they are administering fewer pots, avoiding duplication of administrative tasks and resources. Larger pots, of around £4,000 and above, are easier to charge in a way which does not erode pot size, while also allowing providers to breakeven.

**Policymakers will need to consider the trade-offs for employers, members and providers involved in each policy**

The main trade-offs policymakers will need to consider when choosing between the different policies are outlined below. While the lifetime provider and pot follows member policies reduce the number of deferred pots, member charges and provider costs most significantly, these have potential market drawbacks attached such as significant systemic change (lifetime provider) or placing an increased burden on provider and employer administration (pot follows member). Therefore, other policies with less significant drawbacks or a combination of policies are worth considering (Table Ex.1):

1 PPI modelling

Table Ex.1: policy option trade-offs<sup>2</sup>

Policy	Trade-offs	
	Potential positives	Potential negatives
Dashboards	<ul style="list-style-type: none"> <li>• Encourages engagement</li> </ul>	<ul style="list-style-type: none"> <li>• Potential for lower levels of consolidation</li> </ul>
Same provider consolidation	<ul style="list-style-type: none"> <li>• Simplicity</li> <li>• Reduces administrative burden on providers and employers</li> </ul>	<ul style="list-style-type: none"> <li>• Less comprehensive coverage</li> <li>• Potential for “cherry picking”</li> </ul>
Pot follows member	<ul style="list-style-type: none"> <li>• More comprehensive coverage</li> <li>• Reduces administrative burden on employers</li> </ul>	<ul style="list-style-type: none"> <li>• Increased pot erosion resulting from transfers to schemes with higher fees</li> <li>• Increased administrative burden for providers</li> <li>• Potential for “cherry picking”</li> </ul>
Member exchange	<ul style="list-style-type: none"> <li>• A simpler version of pot follows member</li> </ul>	<ul style="list-style-type: none"> <li>• Less comprehensive coverage than pot follows member</li> <li>• Delay in transfers leading to pot erosion</li> <li>• Potential for “cherry picking”</li> </ul>
Lifetime provider	<ul style="list-style-type: none"> <li>• Policy simplicity</li> <li>• Ease of administration</li> <li>• Most comprehensive coverage</li> </ul>	<ul style="list-style-type: none"> <li>• Unfair competitive advantage</li> <li>• Significant systemic change</li> <li>• Increased administrative burden for employers</li> <li>• Potential for “cherry picking”</li> <li>• Delay, leading to small pot generation</li> </ul>
Default consolidator	<ul style="list-style-type: none"> <li>• More comprehensive coverage</li> <li>• Provides for those who change jobs frequently or move in and out of work</li> <li>• Low administrative burden on employers</li> </ul>	<ul style="list-style-type: none"> <li>• Unfair competitive advantage</li> <li>• Delay in transfers leading to pot erosion</li> <li>• Potential for “cherry picking”</li> </ul>

There are several policy options for dealing with potential negative outcomes associated with the above policy options:

#### Dashboards will complement other consolidation policies

The potential for lower levels of consolidation, associated with dashboards, which require active engagement from members, could be tackled by ensuring that dashboards are used to complement one or more additional policy approaches to reducing the number of small, deferred member pots, such as the others discussed in this report.

#### Regulation on charging could support pot follows member

While it will be particularly difficult to avoid pots being transferred to higher charging schemes from time to time in a pot follows members approach, there is scope for legislative protection. The requirements of master trust authorisation and Chairs Statements on value for money are intended to ensure member protection against unduly high charges. Charges may in fact become more homogenous over time as a result of the current consultation on the charge cap.<sup>3</sup>

<sup>2</sup> Policies not modelled are not included in the table

<sup>3</sup> DWP (2020)

### **A carousel approach to scheme allocation could help reduce competition issues with the default consolidator and lifetime provider models**

The potential for an unfair competitive advantage associated with the default consolidator and lifetime provider models could be addressed by allocating new members to a scheme from a pre-approved list (based on an authorisation process), ensuring that no one scheme is given undue advantage. Existing members who are already saving could remain with their current provider, so as not to result in too much transferring at policy inception.

### **The lifetime provider model would require changes to the regulatory landscape**

The potential, associated with the lifetime provider policy, for an increased administrative burden on employers who must pay contributions into several different schemes would require the development of a new regulatory framework in order to ensure that lifetime providers can fulfil the role that single providers nominated by an employer fulfil today of:

- Monitoring automatic enrolment compliance on behalf of the Regulator,
- Ensuring that contributions are paid regularly,
- Ensuring that late payments are chased down, and
- Sampling contribution calculations for correctness.

The scale, timeframe and costs of these developments are likely to be high. This policy would also require the development of systems that assist payroll providers to cope with multiple pension schemes being used by one employer. These systems would most likely need to include the development of online tools for facilitating easier pension contributions, that are made available to companies who operate payroll in-house.

### **Limiting policies to certain schemes could prevent members from being transferred out of schemes which offer special benefits**

Some form of scheme opt out, or limiting policy coverage to certain schemes (such as master trusts) may be required in order to ensure that employees are not transferred out of schemes in which the benefits outweigh the potential drawbacks of being a deferred member.

### **Policymakers will need to consider how to address the danger of encouraging “cherry picking” of members**

Most consolidator models carry the danger of encouraging “cherry picking” by schemes. While automatic enrolment itself resulted in some schemes “cherry picking” employers who appeared to offer the most profitable set of members,<sup>4</sup> consolidator schemes could result in schemes vying for the pots of individual members, whose income and contributions appear to offer the most in long-term profit. There would need to be serious attention paid by policymakers to the potential for cherry picking in order to ensure that members with lower incomes are not disadvantaged through mainly saving in schemes which many of the most “profitable” members have left.

4 [www.accountingweb.co.uk/community/industry-insights/insurers-cherry-picking-employers-staging-auto-enrolment-shock](http://www.accountingweb.co.uk/community/industry-insights/insurers-cherry-picking-employers-staging-auto-enrolment-shock); [www.ftadviser.com/2015/08/24/pensions/personal-pensions/providers-not-open-for-sme-auto-enrolment-business-BgA91TYsqDkkbuQ32hznzEI/article.html](http://www.ftadviser.com/2015/08/24/pensions/personal-pensions/providers-not-open-for-sme-auto-enrolment-business-BgA91TYsqDkkbuQ32hznzEI/article.html)

### **Increases in cost efficiency will result in greater reductions in costs for providers**

Investment and administrative costs vary between providers based on many factors. While all of the policies explored in this report have the potential to reduce the aggregate level of provider costs, by reducing the number of pots which need to be administered, those who already pay lower than average costs will experience greater savings from each policy, and those who pay more will experience less. Under an assumption that provider admin costs are +/- 25%, of the baseline assumption (£19pa for an active pot and £13pa for a deferred pot), greater cost efficiency could result in annual master trust provider costs of around £640m per year under pot follows member and around £630m under the lifetime provider policy. With a starting level of higher than average costs, master trust provider cost savings could be less significant, with a total annual provider cost of around £840m per year under pot follows member and around £800m under the lifetime provider policy.

As part of moves towards streamlining transfers and managing contributions, industry may want to explore ways of improving cost efficiency, particularly for providers who outsource their management to third parties.

# Introduction

The number of deferred pension pots in the UK Defined Contribution (DC) master trust market is likely to rise from 8m in 2020 to 27m in 2035. Member charges generally erode small, deferred member pots over time and small pots can also be financially unsustainable for providers to manage. Altering charging structures is unlikely to solve the problems associated with small, deferred member pots, as charges either erode member pots or prevent schemes from breaking even on pot management. Any costs providers are unable to recover through the current system will need to eventually be passed on to members through higher charges. If DC pension pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation, is required.

This report explores the potential outcomes on the number of deferred pension pots, charges for members and costs for providers of a range of policy options.

**Chapter One** examines the potential effects of maintaining small, deferred member pots on key stakeholders, particularly on members and pension providers.

**Chapter Two** explores how well different policy approaches could mitigate the negative consequences of small, deferred member pots for members and pension providers.

# Chapter One: Why are small, deferred member pots a problem?

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This Chapter examines the potential effects of maintaining small, deferred member pots on key stakeholders, particularly on members and pension providers.

## Main findings of this chapter

The continuing growth of the number of small, deferred, workplace pension pots is likely to result in a negative impact on all key stakeholders:

All charging structures present sustainability problems for small pension pots: structures including flat-fees, the standard within master trusts, erode small pot sizes; Annual Management Charges (AMC) without flat-fees mean pots cost providers more to manage than they receive in charges.

Any costs that providers are unable to recover through the current system will need to eventually be passed on to members through higher charges.

Policies aimed at consolidating pots, to bring them up to a sufficient size, are a necessary element of any debate regarding how to reduce the negative impacts of small, deferred member pots.

## A large number of small, deferred pots have arisen as a result of automatic enrolment

Automatic enrolment requires employers to enrol eligible employees into a qualifying workplace pension scheme and pay a minimum contribution with employees of 8% of band earnings (£6,240 - £50,000, 2020/21) on behalf of employees who do not opt out. The automatic enrolment policy rolled out from 2012, reaching all employers by 2019. Policymakers were concerned prior to policy inception about the potential for the accumulation of small, deferred pots, arising from employees changing jobs after short periods of employment, and the corresponding economic difficulties small pots could pose for both members and providers.

Two main models were proposed to tackle the potential for many small pots: a pot follows member model and an aggregator model. The pot follows member model, suggested in 2011, involves pots transferring with a member when they change jobs and consolidating with their active pot. The aggregator model involves a large default consolidator scheme, for example, NEST, taking up deferred pots. There was also the suggestion of a dashboard which would allow members to view all of their pension pots in a single place. The pensions dashboards are currently under construction.

In 2012, the aggregator model was dismissed as it would require a low threshold for transfers (in order to avoid market distortion) but might not then lead to significant consolidation.<sup>5</sup> The pot follows member approach was considered in greater detail, and plans were formed regarding a framework for this system, with the legislation required being laid in 2014. In 2015, the plans were discontinued as the then pensions minister felt that the time was not right to ask providers to undergo all of the preparation and adaptation required to support the new system.<sup>6</sup> In 2018, the government briefly considered reinstating the policy, ultimately deciding again in 2019 that it was not the right time for the move as industry was already dealing with a number of changes, including preparation for the pensions dashboards.<sup>7</sup>

## Master trust schemes hold the majority of small, deferred member pots

Prior to automatic enrolment, many employees with higher incomes were already saving into a workplace pension through either a Defined Benefit scheme or a contract-based scheme with a third-party insurer. The majority of those automatically enrolled joined a master trust scheme. Those joining a master trust scheme are more likely to be in the automatic enrolment target group of low earners and more likely to change jobs frequently.<sup>8</sup> As a result, the master trust universe holds the majority of small, deferred member pots. This report focusses mainly on data from master trust schemes and issues concerning these schemes and their members, though most of the concerns and policies could also affect and benefit members of personal pension schemes and single employer trusts.

## The number of deferred members is likely to increase further

The proportion of active<sup>9</sup> and deferred<sup>10</sup> pots under management in master trust schemes as of April 2020 stands at around 50:50.<sup>11</sup> Given the increasing flexibility of the labour market, the proportion of deferred pots will increase as people change jobs (and generally switch providers<sup>12</sup>) throughout their working lives. The number of small pots accrued will also increase when the minimum age of eligibility for automatic enrolment drops from age 22 to age 18 at some point during the mid-2020s (assuming that this recommendation from the automatic enrolment review is enacted) as this will bring more people into saving who are particularly likely to move jobs and work part time or casually.<sup>13</sup> The increase in pot numbers in 2025 (in the chart below) reflects the assumption that the age of eligibility is reduced to age 18 in this year. There are currently 8 million deferred pension pots in master trust schemes, which could increase to around 27m by 2035 without intervention (Chart 1.1).

5 DWP (2012)

6 <https://citywire.co.uk/new-model-adviser/news/comment-its-bizarre-to-resurrect-pot-follows-member-alongside-dashboard/a1061787>

7 <https://www.ft.com/content/e0c62018-4483-11e8-93cf-67ac3a6482fd>

8 Silcock et. al (PPI) (2019)

9 Members still contributing

10 Members no longer contributing

11 PPI analysis of master trust data

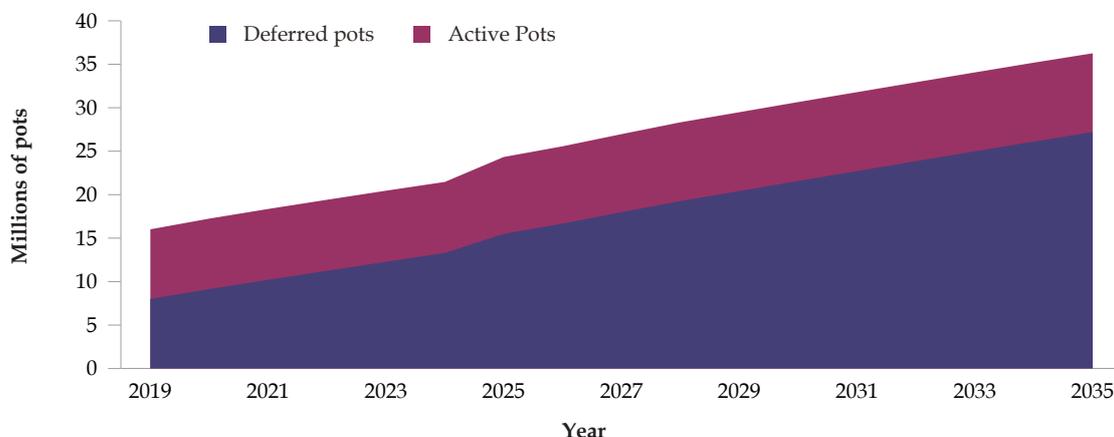
12 Some providers operate a scheme whereby returning members are automatically re-enrolled into their existing pot.

13 DWP (2017)

Chart 1.1<sup>14</sup>

**Without policy change the number of deferred pots could grow from 8m to 27m by 2035**

Projected number of pots among master trust schemes by year, by deferred and active pots, without policy change



**Unemployment arising from the COVID-19 pandemic will increase the number of deferred pots**

The analysis in this report has not taken into account the impact of COVID-19, which will increase the number of deferred pots in the short-term. The impacts of the COVID-19 pandemic are difficult to forecast, however, one expected outcome is an increase in unemployment in the short-term. The Office for Budgetary Responsibility (OBR) predicts a short-term rise in national unemployment from 4% to 10%, that will decrease when people start returning to work.<sup>15</sup> Those who are saving into a pension scheme and lose their jobs will cease contributing to their active pots, and these will become deferred. Many of those who return to

work will start a new pot through either a new scheme or their previous scheme, increasing the number of deferred pots in the system.

The current average pot size within master trust schemes is around £1,000,<sup>16</sup> however, those who work part-time, casually, or for short periods of time can accrue much smaller pots before moving to another job. For example, someone working full-time at the National Living Wage (NLW) (outside London) of £8.72ph, around two months of contributions of 8% of band earnings could result in a pension pot of around £100, seven months could result in a pot of around £500, and 14 months could result in a pot of around £1,000. Those working three days a week could accumulate similar pot sizes over four, 18 and 33 months of contributions (Table 1.1).

Table 1.1 length of time contributing at 8% of band earnings at NLW to achieve different small pot sizes<sup>17</sup>

Pot size	Length of time contributing	
	Full time (months)	Part time (months)
£100	2	4
£500	7	18
£1,000	14	33

14 PPI modelling

15 <https://obr.uk/coronavirus-analysis/>

16 PPI analysis of master trust data

17 PPI modelling

## Small pots are unlikely to help members or providers

Small pots are problematic for members and providers. For members there is the potential that pots may be:

- Eroded by charges and potentially reduced to £0,
- Too small to contribute in any meaningful way to retirement income; in many cases members will withdraw small pots as a lump sum at retirement, rather than putting them towards their retirement income.<sup>18</sup>
- ‘Lost’ over time, due to members forgetting they own the pot and providers losing track of members’ latest addresses. The number of lost pension pots in 2018 was estimated at around 800,000.<sup>19</sup>

For providers, managing a large number of small pots:

- Could threaten financial sustainability, as providers may not receive a sufficient amount in charges to cover administration costs. Threats to financial sustainability could ultimately result in the winding up of schemes as the master trust authorisation scheme requires trustees to declare a triggering event to wind up schemes if they are concerned the schemes are becoming unstable.<sup>20</sup>

## Standard charges will generally erode small pots or result in insignificant growth

Small, deferred member pots can be eroded and diminished to £0 from provider charges, despite investment returns. Pots of between £100 and £500 are particularly at risk. These types of pot sizes can easily arise if members work part-time, or earn at low levels, for a short period of time, and then move on (Table 1.1). The following analysis illustrates the potential effects of charges on small pots,<sup>21</sup> using three different charging structures:

- A 0.5% Annual Management Charge (AMC) only

- A £24 annual flat-fee only
- A combination of a £20 annual fee and 0.25% AMC

Some master trust schemes operate a de minimis pot amount (for example, £50), below which flat-fees are not charged. However, these are not considered in the modelling.<sup>22</sup>

The cost of administering schemes each year is based upon the total costs incurred by providers and reported in their accounts,<sup>23</sup> alongside confidential interviews with the providers and regulator including validation of these assumptions. The assumptions used were:

- Investment related expense of 0.15% of assets under management.
- Additional annual administrative costs of around £20 per active pot per year and around £13 per deferred pot. These costs are assumed to increase in line with projected earnings (taken from OBR determinants).

The scenarios are not meant to replicate any existing charging structures, but to explore the differences between approaches. They assume a pot with no further contributions from age 22 and age 40, and a future retirement age of 68.

## Charging structures with a flat-fee element run the risk of eroding small pension pots to zero

Small pots are unlikely to make a significant contribution to member retirement incomes, and many of those which are accrued may be eroded by charges. A flat-fee only approach will leave a £100 pot depleted within five years, and a combination approach will deplete the same pot within six years. The AMC only approach will leave a pot of around £200 (if deferred at 22) or around £800 (if deferred at age 40) (2020 earnings terms) at the member’s State Pension age (SPa). Because an AMC only approach charges at a percentage of pot size, it can never reduce a pot to zero, whereas charging structures that includes a flat-fee will continue to withdraw the same amount irrespective

18 FCA (2019)

19 Pensions Policy Institute (2018) Briefing note 110; Lost pensions: what’s the scale and impact?

20 [www.thepensionsregulator.gov.uk/en/master-trust-pension-schemes/supervision-of-master-trusts/master-trust-triggering-events-and-authorisation](http://www.thepensionsregulator.gov.uk/en/master-trust-pension-schemes/supervision-of-master-trusts/master-trust-triggering-events-and-authorisation)

21 The models were designed to show the broad effects of different charging structures without replicating real world examples. The figure of 0.5% AMC or equivalent is in line with average charges in UK automatic enrolment master trust schemes.

22 For example, Creative Pension Trust

23 Appendix Table 1

of the size of the pot. However, an AMC only approach will mean that providers are unable to recover their costs on small pots.

A £500 pot, deferred from age 22, with a flat-fee only charge could be eroded to £0 by age 63,

and could be worth £100 by age 68 if deferred from age 40. A £1,000 pot deferred from age 22 would be worth around £1,400 by age 68, and, if deferred from age 40, worth around £1,100 by age 68 (2020 earnings terms) (Table 1.2).

Table 1.2<sup>24</sup>

Charging structure	Pot size at age 68					
	Deferred at age 22			Deferred at age 40		
	£100	£500	£1,000	£100	£500	£1,000
Baseline – no charge	£300	£1,500	£3,000	£200	£1,000	£1,900
0.5% AMC only	£200	£1,200	£2,400	£200	£800	£1,700
£20 annual flat-fee and 0.25% AMC	£0	£100	£1,400	£0	£200	£1,100
£24 annual flat-fee only	£0	£0	£1,400	£0	£100	£1,100

While small, deferred pots may be eroded by flat-fee charges, larger pots will be eroded less over time by a combination charge involving a flat-fee + an AMC, than an AMC only, as larger pots will be charged proportionally less through a flat-fee as they grow.<sup>25</sup>

### Pots below £4,000 can be unsustainable for providers to manage, if they charge through an AMC only

For pension providers who charge an AMC only, small, deferred pots are generally financially unsustainable, and the costs associated with continuing to administer them may end up being cross subsidised by active members, which could raise issues of fairness.

Even if an AMC at the highest permissible rate was charged (0.75%<sup>26</sup>), the costs associated with running a scheme would require an average pot size of around £2,300 for the provider to breakeven (to be spending less or the same amount on administering the pot as the member pays in fees).<sup>27</sup> When this is reduced to nearer the industry average AMC of 0.5% or equivalent, the required average pot size to breakeven grows to just under £4,000.

Alongside administrative and investment costs, workplace pension schemes (trust and contract based) must pay a levy to The Pensions Regulator to cover their services as well as those

provided by the Pensions Ombudsman and the Pensions Advisory Service.<sup>28</sup> Large master trusts are required to pay a General Levy and a Fraud Levy of around 90p per member.<sup>29</sup> Smaller master trusts are required to pay more. A 0.5% AMC would require a pot of at least £180 to fund a 90p per pot levy and more than this in order to pay for administrative and investment costs. Larger levies would require larger pots to cover these.

### The growth of small pots is likely to result in an increase in cross-subsidy from members with larger pots

There are currently around 16m DC pots and the average pension pot size, in master trust schemes is around £1,000<sup>30</sup> in 2020. Around 8m of these are small, deferred pots held by providers, and many providers may be not be yielding sufficient charges to cover the direct running costs of these pots. As the number of small pots increases, some members with higher pension savings will effectively be cross-subsidising these smaller pots, which could impact upon their own retirement incomes, and may lead to unrest among members if they become aware.

Unrest between pension scheme members has developed in other countries as a result of perceived unfairness in subsidisation, for

24 PPI modelling

25 Baker, M. (PPI) (2019)

26 PPI modelling assumes investment costs of 0.15%

27 Based on PPI analysis of master trust accounts

28 Now under the umbrella of the Money and Pensions Service

29 NOW: Pensions data

30 PPI interview with industry representatives

example, many younger occupational pension scheme members in Holland feel unfairly affected by the shift to a DC model which alters previous contribution patterns. Under the previous Dutch model, older workers contributed more to compensate for the decreasing time horizon of their investments. Under the new system, all contributions will be paid at the same percentage, meaning older workers will not benefit from the same subsidisation which they provided to previous retired members.<sup>31</sup> Unrest and perceived unfairness by members can erode trust in and support for pensions and may ultimately affect participation rates.

### Conclusion:

#### **Policies aimed at consolidating pots are likely to provide a better long-term solution than tackling charging structures**

Altering charging structures is unlikely to resolve the problems associated with small, deferred member pots, as all charges either erode member pots or prevent schemes from breaking even on charges. Small pots are also unlikely to contribute significantly to retirement incomes and may become lost, or withdrawn as lump sums, rather than be put towards retirement income products. If pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation is required. Though keeping charges reasonable, proportionate and transparent will always have an important impact on member outcomes.

Chapter Two will outline some policy models for consolidation and examine the benefits and drawbacks for different stakeholders.

31 [www.ipe.com/news/dutch-dc-pension-switch-includes-lifecycles-personal-pension-pots/10046409.article?adredir=1](http://www.ipe.com/news/dutch-dc-pension-switch-includes-lifecycles-personal-pension-pots/10046409.article?adredir=1)

# Chapter Two: How can the number of small, deferred member pots be reduced?

**This Chapter explores how well different policy approaches could mitigate the negative consequences of small, deferred member pots for members and pension providers.**

This chapter was informed by a roundtable held by the PPI with key stakeholders in industry. Each policy approach was discussed, and the attendees provided views on key benefits and drawbacks for industry and members.

## Main findings of this chapter

With all policies, there are trade-offs to consider. All policies have drawbacks and benefits, and the relative merits may be viewed differently by different audiences.

Judging solely on the impact on member pots, member charges and provider costs, the lifetime provider and pot follows member models generate more favourable outcomes.

However, these policy models are likely to increase the administrative burden on employers or providers and the lifetime provider model would involve significant systemic change and could result in some schemes receiving a competitive advantage.

Consideration by policymakers will need to involve all the potential trade-offs associated with each model and how policy levers may mitigate potential negative outcomes.

A combination of policies may be necessary to maximise benefits while minimising potential drawbacks.

In order to successfully deliver a policy to reduce the number of small pots, a degree of consensus among consumer and employer representatives, industry, Government and regulators (all affected parties) will be necessary, and therefore all these groups should be included in the decision-making process.

The following section outlines the various policy approaches explored in this chapter, based on a selection of those discussed publicly or anecdotally within industry:

- **Dashboards:** platforms that allow members to view all pots with different providers in one place and could facilitate more consolidation, though this is not the primary aim of dashboards.

- **Same provider consolidation:** returning members are re-enrolled into their deferred pot.

- **Pot follows member:** pots move with members to new employer's schemes.

- **Member exchange:** a form of pot follows member, which allows for the reassignment between schemes of all existing pots into the current active scheme.

- **Lifetime provider:** members remain with the same provider throughout their working life.

- **Default consolidator:** pots deferred for a year transfer to a consolidator provider, with members being given an opportunity to opt out.

#### Box 2.1: alternative policies

Three other policy options were discussed at the roundtable but were not taken forward:

- **Refunds:** pots of a pre-specified size are refunded if a member ceases to contribute and/or leaves their employer.
- **Government consolidator:** deferred pots below a threshold automatically transfer to a central government consolidator vehicle or, alternatively, become subsumed into government funding and are allocated to fund State Pension payments.
- **Commercial consolidation:** A consolidator would be nominated by a first employer and be used for life. Pots could be transferred when an individual leaves a scheme with a pot size below a specific value, or, alternatively, all deferred pots could be transferred.<sup>32</sup>

The policies taken forward were those thought most practical and most likely to be considered seriously, by the roundtable with industry experts. The roundtable did not consider member refunds worth further exploration as they would involve more loss to member retirement income than the current system and would run counter to the intention behind automatic enrolment. However, refunds may still form part of a consolidation policy if, for example, they were used only for "micro-pots" of a few pounds, accrued by people who do not wish to save but did not send in their opt-out form in time. Pots of a few pounds are unlikely to be worth consolidating and will present administrative difficulties to both the provider and member.

The roundtable also discussed commercial consolidation, but it was widely agreed that a single default consolidator would disrupt the automatic enrolment market and prove uncompetitive as some providers may be unwilling to retain or accept smaller pots. The Government consolidator vehicle, though similar to the model used for the Australian Superannuation Fund, was not perceived to be translatable to the UK as a result of competition issues.

The analysis in this chapter is not intended to form a prediction of the number of future pots, member charges or provider costs, but rather intends to illustrate the different potential outcomes from policies designed to reduce the number of small, deferred member pots (Box 2.2).

32 Commercial consolidators (e.g., "super funds") are entering the DB endgame market. Similar consolidators could also play a role in providing a destination for multiple small pension pots on economies of scale.

Box 2.2: modelling assumptions and baseline results

The following analysis assumes:

- On average, by 2035, for each active pot there will be three deferred pots.<sup>33</sup>

Without policy change:

- The overall annual costs to providers of managing pots (active and deferred) within the master trust landscape will reach £1bn by 2035 (2020 earnings terms),<sup>34</sup>
- Overall annual member charges will reach £1.2bn by 2035 (2020 earnings terms),
- The number of total pots will reach 36m by 2035 (9m active and 27 deferred).<sup>35</sup>

**Consolidator models reduce the number of deferred member pots to varying degrees**

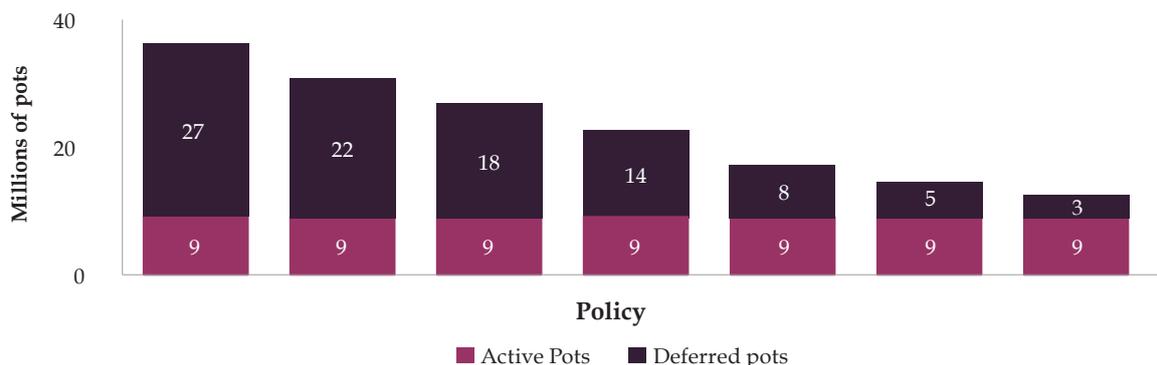
Out of all the policy models explored, the lifetime provider model reduces the number of deferred member pots in master trusts the most

significantly, resulting in around 3m deferred pots by 2035. Pot follows member has the next most significant impact on deferred member pots, reducing them to 5m pots by 2035. The other policies have a range of impacts, reducing deferred pots to between 14m and 22m pots by 2035 (Chart 2.1).

Chart 2.1<sup>36</sup>

**Consolidator models reduce the number of deferred member pots to varying degrees**

Number of active and deferred pots in master trust universe by 2035 under different policy models



Consolidation reduces member charges and provider costs, as it results in members paying for fewer pots and providers duplicating fewer administrative tasks. The lifetime provider model reduces costs and charges most significantly, resulting in minimum annual master trust member charges of around £920m and minimum annual master trust provider costs of around £680m by 2035. Pot follows

member has the next most significant impact on costs and charges, reducing aggregate member charges to a minimum annual cost of around £930m and provider costs to a minimum annual cost of around £700m by 2035. The other policies have a range of impacts, reducing annual member charges to between £1bn and £1.1bn, and annual provider costs to between £810m and £920m by 2035 (Chart 2.2).

33 Derived from industry data

34 These costs encompass both administration and investment charges.

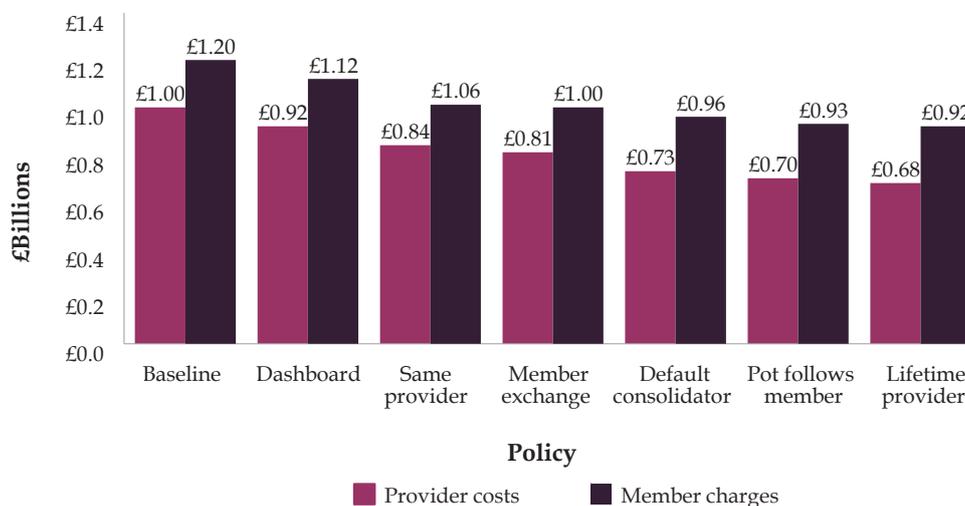
35 PPI Aggregate Model

36 PPI modelling

Chart 2.2<sup>37</sup>

### Member charges and provider costs are reduced to varying degrees under all consolidator models

Annual, aggregate member charges and provider costs in master trust schemes by 2035 under different policy models



### Increases in individual scheme cost efficiency will result in greater reductions in costs for providers from consolidation policies

Investment and administrative costs vary between providers based on many factors including:

- Size and value of scheme
- Whether admin and investment services are managed in house or by a third party
- Charges levied by third parties

While all of the policies explored in this report have the potential to reduce the aggregate level of provider costs, those who already pay lower

than average costs will experience greater savings from each policy, and those who pay more will experience less. This report assumes an annual cost to master trust providers of around £20 per active pot per year and around £13 per deferred pot. In order to demonstrate the potential range of policy impact on charges, the analysis assumes a wider range of costs (+/- 25%) and explores the potential impact of the pot follows member and lifetime provider models under these. The assumptions involve:

- A high cost scenario of £25 for an active pot and £16 for a deferred pot
- A low-cost scenario of £15 for an active pot and £10 for a deferred pot

Under these scenarios, greater cost efficiency could result in annual master trust provider costs of around £640m per year under pot follows member and around £630m under the lifetime provider policy, by 2035. With higher than average costs, master trust provider costs could be higher under each policy, at around £840m per year under pot follows member and around £800m under the lifetime provider policy by 2035 (Chart 2.3, Chart 2.4).

Chart 2.3<sup>38</sup>

**Under pot follows member, greater cost efficiency could result in a cost minimum of around £640m, and less cost efficiency could result in costs of up to around £840m by 2035**

Annual aggregate member charges and provider costs of managing pots among master trust schemes by year, 2020 earnings terms under scenarios of high and low costs

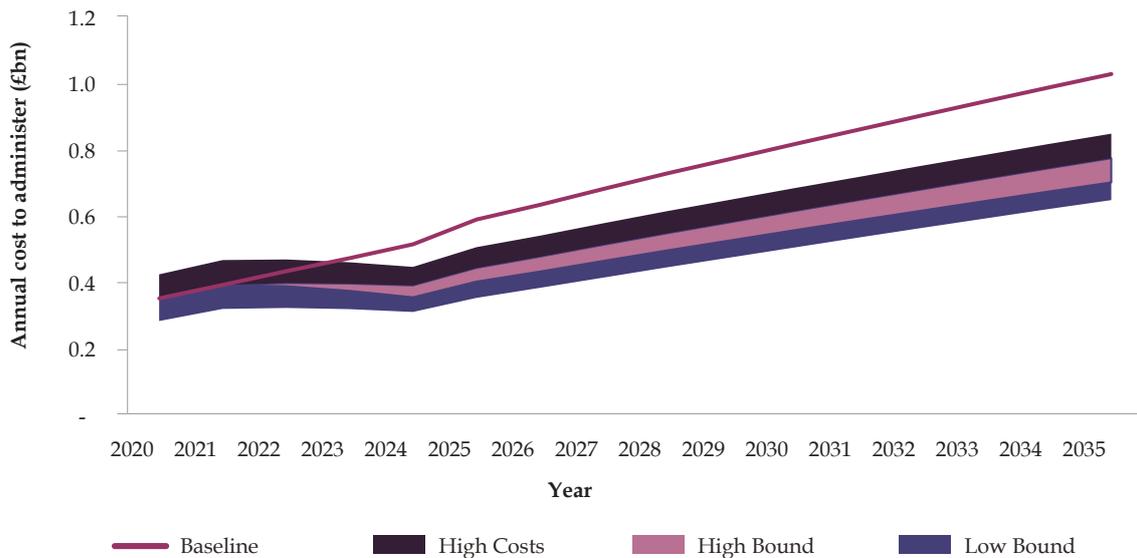
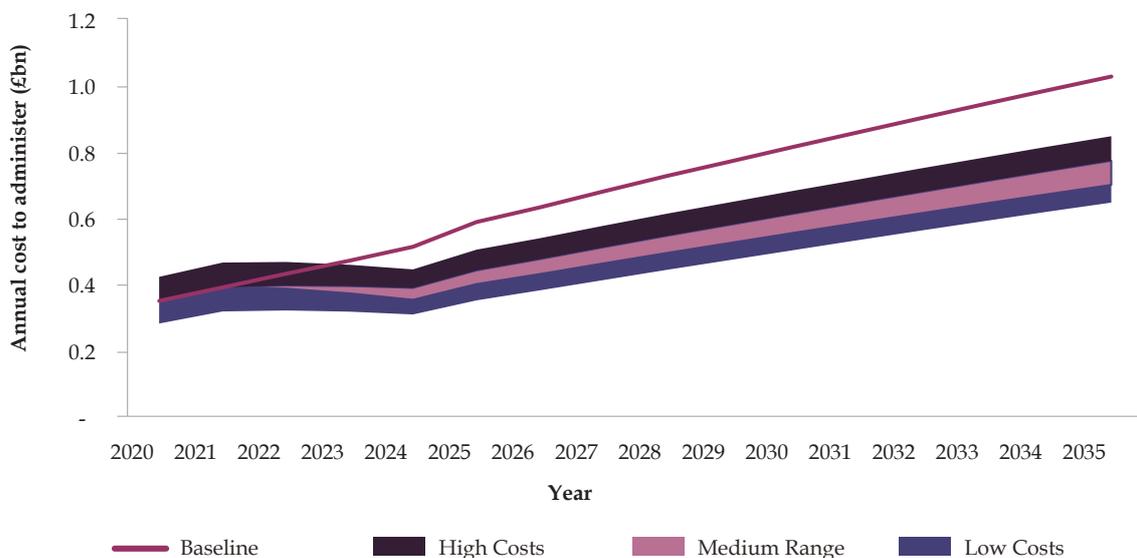


Chart 2.4<sup>39</sup>

**Under a lifetime provider model, greater cost efficiency could result in a cost minimum of around £630m, and less cost efficiency could result in costs of up to around £800m by 2035**

Annual aggregate member charges and provider costs of managing pots among master trust schemes by year, 2020 earnings terms under scenarios of high and low costs



38 PPI modelling

39 PPI modelling

## Policymakers will need to consider the trade-offs for employers, members and providers involved in each policy

The main trade-offs policymakers will need to consider when choosing between the different policies are outlined below (Table 2.1):

Table 2.1: policy option trade-offs<sup>40</sup>

Policy	Trade-offs	
	Potential positives	Potential negatives
Dashboards	<ul style="list-style-type: none"> <li>Encourages engagement</li> </ul>	<ul style="list-style-type: none"> <li>Potential for lower levels of consolidation</li> </ul>
Same provider consolidation	<ul style="list-style-type: none"> <li>Simplicity</li> <li>Reduces administrative burden on providers and employers</li> </ul>	<ul style="list-style-type: none"> <li>Less comprehensive coverage</li> <li>Potential for “cherry picking”</li> </ul>
Pot follows member	<ul style="list-style-type: none"> <li>More comprehensive coverage</li> <li>Reduces administrative burden on employers</li> </ul>	<ul style="list-style-type: none"> <li>Increased pot erosion resulting from transfers to schemes with higher fees</li> <li>Increased administrative burden for providers</li> <li>Potential for “cherry picking”</li> </ul>
Member exchange	<ul style="list-style-type: none"> <li>A simpler version of pot follows member</li> </ul>	<ul style="list-style-type: none"> <li>Less comprehensive coverage than pot follows member</li> <li>Delay in transfers leading to pot erosion</li> <li>Potential for “cherry picking”</li> </ul>
Lifetime provider	<ul style="list-style-type: none"> <li>Policy simplicity</li> <li>Ease of administration</li> <li>Most comprehensive coverage</li> </ul>	<ul style="list-style-type: none"> <li>Unfair competitive advantage</li> <li>Significant systemic change</li> <li>Increased administrative burden for employers</li> <li>Potential for “cherry picking”</li> <li>Delay, leading to small pot generation</li> </ul>
Default consolidator	<ul style="list-style-type: none"> <li>More comprehensive coverage</li> <li>Provides for those who change jobs frequently or move in and out of work</li> <li>Low administrative burden on employers</li> </ul>	<ul style="list-style-type: none"> <li>Unfair competitive advantage</li> <li>Delay in transfers leading to pot erosion</li> <li>Potential for “cherry picking”</li> </ul>

### Dashboards will complement other consolidation policies

The potential for lower levels of consolidation, associated with dashboards, which require active engagement from members, could be tackled by ensuring that dashboards are used to complement one or more additional policy approaches to reducing the number of small, deferred member pots, such as the others discussed in this report.

### Regulation on charging could support pot follows member

While it will be particularly difficult to avoid pots being transferred to higher charging schemes from time to time in a pot follows members approach, there is scope for legislative protection. The requirements of master trust authorisation and Chairs Statements on value for money are intended to ensure member protection against unduly high charges. Charges may in fact become more homogenous over time as a result of the current consultation on the charge cap.<sup>41</sup>

<sup>40</sup> Policies not modelled are not included in the table

<sup>41</sup> DWP (2020)

### **A carousel approach to scheme allocation could help reduce competition issues with the default consolidator and lifetime provider models**

The potential for an unfair competitive advantage associated with the default consolidator and lifetime provider models could be addressed by allocating new members to a scheme from a pre-approved list (based on an authorisation process), ensuring that no one scheme is given undue advantage. Existing members who are already saving could remain with their current provider, so as not to result in too much transferring at policy inception.

### **The lifetime provider model would require changes to the regulatory landscape**

The potential, associated with the lifetime provider policy, for an increased administrative burden on employers who must pay contributions into several different schemes would require the development of a new regulatory framework in order to ensure that lifetime providers can fulfil the role that single providers nominated by an employer fulfil today of:

- Monitoring automatic enrolment compliance on behalf of the Regulator,
- Ensuring that contributions are paid regularly,
- Ensuring that late payments are chased down, and
- Sampling contribution calculations for correctness.

The scale, timeframe and costs of these developments are likely to be high. This policy would also require the development of systems that assist payroll providers to cope with multiple pension schemes being used by one employer. These systems would most likely need to include the development of online tools for facilitating easier pension contributions, that are made available to companies who operate payroll in house.

### **Limiting policies to certain schemes could prevent members from being transferred out of schemes which offer special benefits**

Some form of scheme opt out, or limiting policy coverage to certain schemes (such as master trusts) may be required in order to ensure that employees are not transferred out of schemes in which the benefits outweigh the potential drawbacks of being a deferred member.

### **Policymakers will need to consider how to address the danger of encouraging “cherry picking” of members**

Most consolidator models carry the danger of encouraging “cherry picking” by schemes. While automatic enrolment itself resulted in some schemes “cherry picking” employers who appeared to offer the most profitable set of members<sup>42</sup> consolidator schemes could result in schemes vying for the pots of individual members, whose income and contributions appear to offer the most in long-term profit. There would need to be serious attention paid by policymakers to the potential for cherry picking in order to ensure that members with lower incomes are not disadvantaged through mainly saving in schemes which many of the most “profitable” members have left.

As part of moves towards streamlining transfers and managing contributions, industry may want to explore ways of improving cost efficiency, particularly for providers who outsource their management to third parties.

The next section of this chapter individually analyses the potential impact of these policies on master trust members and providers in greater detail.

**Pensions dashboards will not require additional development from providers, beyond the existing obligations to provide data, but are also least likely to dramatically reduce the number of small pots**

The 2016 Budget announced the introduction of pensions dashboards that would allow individuals to view their own pension portfolios. The Government is currently working on providing a publicly run dashboard alongside several industry hosted dashboards.

42 [www.accountingweb.co.uk/community/industry-insights/insurers-cherry-picking-employers-staging-auto-enrolment-shock](http://www.accountingweb.co.uk/community/industry-insights/insurers-cherry-picking-employers-staging-auto-enrolment-shock); [www.ftadviser.com/2015/08/24/pensions/personal-pensions/providers-not-open-for-sme-auto-enrolment-business-BgA91TYsqDkkbuQ32hnzEI/article.html](http://www.ftadviser.com/2015/08/24/pensions/personal-pensions/providers-not-open-for-sme-auto-enrolment-business-BgA91TYsqDkkbuQ32hnzEI/article.html)

Assuming between 10% and 30% of deferred pots are consolidated as a result of dashboards, master trust providers could save between £40m and £110m annually on overall administration costs (2020 earnings terms)

Dashboards have the potential to increase consolidation and could reduce some costs for providers. However, on their own, dashboards are unlikely to result in a significant level of pot consolidation as members will be required to take active decisions to consolidate. In Australia, where dashboards are already available and pension pot transfers are administratively simple, only 30% have made an active choice to switch their current pot to a different provider.<sup>43</sup>

Pensions dashboards could result in some members choosing to consolidate, and, once the dashboards are up and running, consolidation may become more streamlined (as a result of more uniformity on data sharing between schemes). However, the true extent of behavioural impact is difficult to predict.

Decisions to consolidate are more likely to take place at older ages, when sufficient funds have accumulated to engage members. Therefore, the following analysis assumes that consolidation takes place at age 58. Based on an assumption of between 10% to 30% (an expectation of lower take up than Australia by 2035, especially as dashboards are still under construction) consolidation arising from the use of pension dashboards:

- Total annual master trust provider costs could reach between £920m and £990m by 2035, compared to £1bn under the baseline.<sup>44</sup>
- Total annual master trust member charges could reach between £1.12bn and £1.18bn by 2035, compared to £1.2 under the baseline.<sup>45</sup>
- Total annual master trust pots could reach 31m by 2035, compared to 36m under the baseline.<sup>46</sup>

Pensions dashboards are a useful tool to use in combination with other consolidator policies

It is important to recognise that dashboards are not intended solely to facilitate transfers, but instead are meant to provide savers with comprehensive information about their retirement saving to help decision-making about planning and preparing for later life. Though some may choose to consolidate as a result of dashboard use, many may simply use the information to make decisions about future savings levels and

access. Therefore, dashboards are likely to add value in many ways beyond simply encouraging consolidation. While not necessarily offering a significant opportunity to reduce the number of small, deferred member pots, dashboards should provide a useful complement to other consolidation policies by helping members to make more informed decisions.

### **Same provider consolidation is less resource heavy for providers but means that members will reach retirement with a greater number of pots and not all small pots will be consolidated**

The same provider consolidation policy is based on a policy already existing within some schemes (for example, NEST). This policy entails members who leave and re-join the scheme re-joining their deferred pot, so they never have more than one pot per scheme. As master trusts tend to target particular industries, it can be expected that many savers will be enrolled in the same scheme through different employers and benefit from a policy which aggregates their pots into one.

The same provider policy should be easier for schemes to administer than a policy requiring pots to transfer into and out of schemes upon every job change. However, the policy will not ensure all deferred member pots are consolidated, as members who save with more than one provider may accrue one or more small, deferred pots which they never re-join.

The below analysis assumes that people switch between three master trusts on average during their working life, accruing around three pots in each scheme. The single provider consolidation results in nine total pots being reduced to three (one with each provider) for members. Based on an assumption of between 20% to 50% consolidation arising from use of same provider consolidation policy:

- Total annual master trust provider costs could reach between £840m and £950m by 2035 compared to £1bn under the baseline.<sup>47</sup>
- Total annual master trust member charges could reach between £1.06bn and £1.15bn by 2035, compared to £1.2bn under the baseline (Chart 2.5).<sup>48</sup>
- Total annual master trust pots could reach 27m by 2035, compared to 36m under the baseline.<sup>49</sup>

43 <https://www.choice.com.au/money/financial-planning-and-investing/superannuation/buying-guides/super>

44 PPI modelling; the modelling assumes that investment charges remain the same for schemes, as these are not pot size dependent, but that admin costs are reduced through pot consolidation.

45 PPI modelling

46 PPI modelling

47 PPI modelling; the modelling assumes that investment charges remain the same for schemes, as these are not pot size dependent, but that admin costs are reduced through pot consolidation.

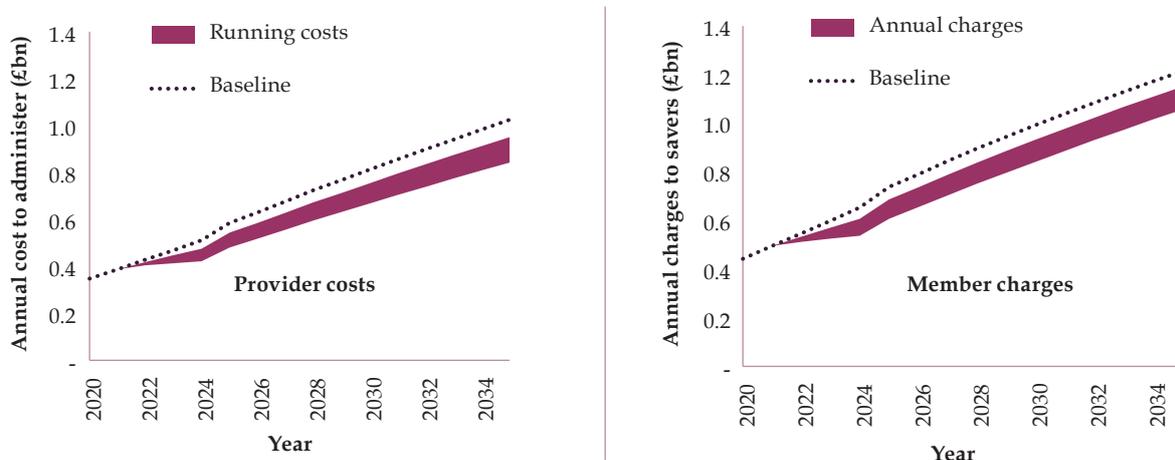
48 PPI modelling

49 PPI modelling

Chart 2.5<sup>50</sup>

**Same provider consolidation could reduce annual member charges from £1.2bn to £1.06bn and provider costs from £1bn to £840m, by 2035**

Annual aggregate member charges and provider costs of managing pots among master trust schemes by year, 2020 earnings terms



**Pot follows member is an efficient way to avoid pot erosion and lost pots but is resource heavy for providers and employers and could lead to members having their pots transferred into higher charging schemes**

The pot follows member policy, first mooted in 2011 as a way of preventing the build-up of small pots under automatic enrolment,<sup>51</sup> provides for pots following members when they move to a new employer and are automatically enrolled. Pot follows member has been discussed and dismissed several times, due to worries about administration and the potential for members to be moved from a low charging scheme to a high charging scheme. However, the legislation required to implement pot follows member has been laid, in the Pensions Act 2014, and only now requires the detail to be set out.

The following PPI analysis assumes that, on a pot follows member policy first being introduced, previous deferred pots are brought into the current scheme on the first new automatic enrolment or automatic re-enrolment. Each subsequent new automatic enrolment (on job change) would lead to the previous pot being brought into the new scheme. PPI analysis assumes that pot follows member would result in 70% to 90% of deferred pots being consolidated, as some members may accrue small, deferred pots without any subsequent automatic enrolment. Based on an assumption of between 70% to 90% consolidation arising from use of pot follows member:

- Total annual master trust provider costs could reach between £700m and £770m by 2035, compared to £1bn under the baseline.<sup>52</sup>
- Total annual master trust member charges could reach between £930m and £990m by 2035, compared to £1.2bn under the baseline (Chart 2.6).
- Total master trust landscape pots could reach 15m by 2035 (9m active and 6m deferred), compared to 36m under the baseline.

50 PPI modelling

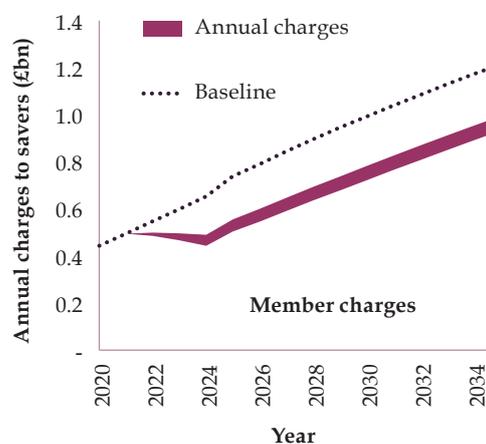
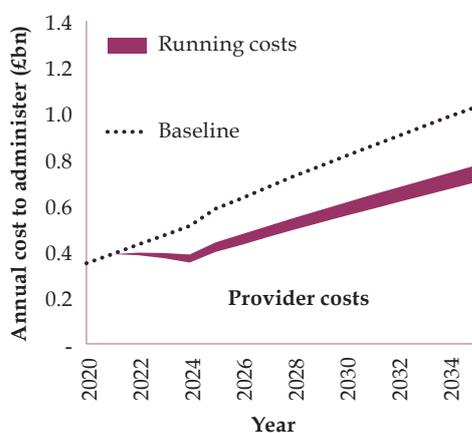
51 DWP (2011)

52 The modelling assumes that investment charges remain the same for schemes, as these are not pot size dependent, but that admin costs are reduced through pot consolidation.

Chart 2.6<sup>53</sup>

### Pot follows member could reduce annual saver charges from £1.2bn to £930m and provider costs from £1bn to £700m, by 2035

Annual aggregate member charges and provider costs of managing pots among master trust schemes by year, 2020 earnings terms



The charging structures in destination schemes will affect outcomes and could affect member engagement and satisfaction

If member pots are transferred to a scheme with higher charges than the originator scheme than the pot may lose value more quickly than it would have done without being transferred. This effect could also occur in the lifetime provider system as people may choose, or be defaulted into, saving with a provider who levies higher charges than schemes that members may have joined later on through subsequent employment. The transferring provider could be deemed responsible, by the member, if the member later discovers they were moved to a scheme with higher charges which could result in disengagement and a loss of trust in pensions.

While it will be particularly difficult to avoid pots being transferred to higher charging schemes from time to time in a pot follows members approach, there is scope for legislative protection. The requirements of master trust authorisation and Chairs Statements on value for money are already in place and are intended to ensure member protection against unduly high charges. Another option would be to require an opt out, or opt in, for pots above a certain threshold amount to be transferred, though introducing thresholds can create

other complications, such as resulting in some schemes becoming a receptacle for mainly small pots while others are able to maintain mainly larger pots.

#### Transfer costs could be expensive for providers under pot follows member

Transferring a pot from one provider to another involves administrative time and resources which represent a cost to the provider which are not directly passed on to the member in the majority of master trust schemes. The increase in transfers in and out which would arise from a pot follows member policy would increase the cost of administering the scheme, a cost which would be passed on to providers and eventually, indirectly, to members through charges. If a policy of this nature were introduced, a streamlined system of transfers between schemes which limits the need for significant administrative time to be spent would be important to ensure that providers can keep member charges low. There are already developments towards an industry-wide transfer programme which would help streamline the movement of pots between schemes.<sup>54</sup> The development of similar data sharing models, being facilitated by dashboards, should make it easier to streamline transfer systems.

53 PPI modelling

54 [http://www.tisaexchange.co.uk/other\\_publication.html?type=5](http://www.tisaexchange.co.uk/other_publication.html?type=5)

### Member exchange, a version of pot follows member, would reduce the administrative burden on providers and could save on transfer fees but would slow the consolidation process

An alternative method for implementing pot follows member would be through a “member exchange” programme. Schemes, by mutual agreement, would conduct a regular exercise in which they would “exchange” pots of similar values, with the result that active members would receive funds from deferred pots held by the relevant provider. This policy has the advantage of ensuring that schemes who transfer business out, can also transfer new business in. Member exchange may involve some delay in pot transfers for members but would operate overall as a pot follows member policy. As the administrative exercise for providers would be much simpler, and potentially less expensive, under member

exchange, it may seem a reasonable trade-off to choose this policy over pure pot follows member, even if it means that some small pots may be eroded during the delay.

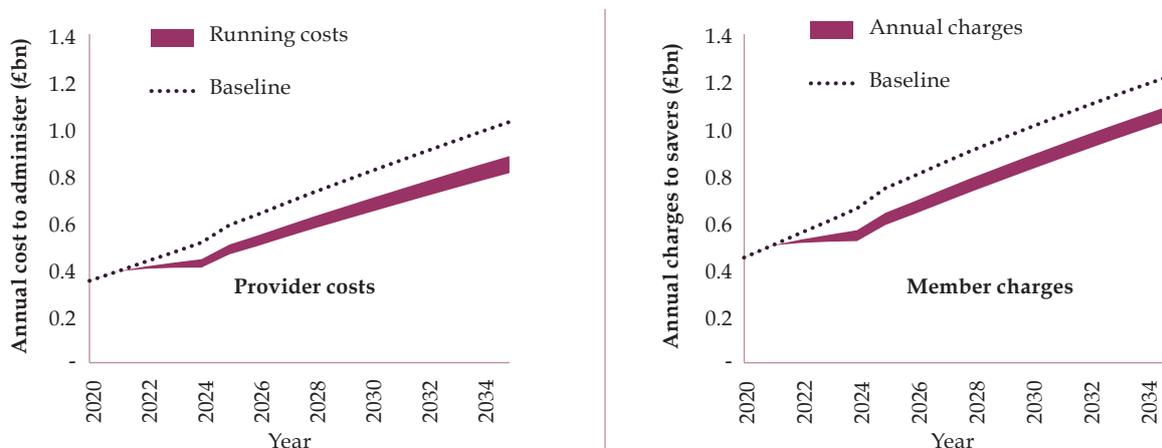
This analysis assumes that in a member exchange policy, exchanges would be automatic after a three-year accumulation period, or upon a pot becoming deferred. Based on an assumption of between 40% to 60% consolidation arising from use of member exchange:

- Total annual master trust provider costs could reach between £810m and £880m by 2035, compared to £1bn under the baseline.<sup>55</sup>
- Total annual master trust member charges could reach between £1bn and £1.1bn by 2035, compared to £1.2bn under the baseline (Chart 2.7).
- Total master trust pots could reach 23m by 2035, (9m active and 14m deferred) compared to 36m under the baseline.

Chart 2.7<sup>56</sup>

### Member exchange could reduce annual saver charges from £1.2bn to £1bn and provider costs from £1bn to £810m, by 2035

Annual aggregate member charges and provider costs of managing pots among master trust schemes by year, 2020 earnings terms



### A lifetime provider model efficiently consolidates pots and avoids pots travelling through schemes with very different charging structures, however, this model is resource heavy for employers and could give some schemes an unfair advantage

A lifetime provider model would involve members choosing or being defaulted into a single scheme which would receive employer/

employee contributions regardless of the member’s employer. A lifetime provider model would prevent providers needing to administer transfers and would result in fewer small pots. On the other hand, this model, would require employers to develop payroll systems in order to pay into many different pots, and may require extra time to be expended on payroll and the administration of contributions.<sup>57</sup>

55 The modelling assumes that investment charges remain the same for schemes, as these are not pot size dependent, but that admin costs are reduced through pot consolidation.

56 PPI modelling

57 Particularly as some schemes use Net Pay and some use Relief at Source for tax relief

There may be an element of delay, which could lead to the generation of small or micro pots, as employees will need to inform employers of who their lifetime provider is. If employees do not notify their employer in time, the employee will be automatically enrolled into the employer's current scheme. This delay could lead to the generation of a small or micro

pot that is left once the employer switches to contributing to the employee's lifetime provider. The following analysis does not include an assumption regarding this potential delay, however, if the policy were implemented, policymakers would need to consider a way of ensuring it does not lead to the creation of many small or micro pots.

The following case study provides an example of how a lifetime provider model might work in practice (Box 2.3).

### Box 2.3

#### Lifetime providers – the Irish model<sup>58</sup>

Proposals for the introduction of automatic enrolment in Ireland have been based on a lifetime provider model. Under this scheme:

- A Central Processing Authority (CPA) will be established by the State and will be responsible for accrediting via an open tender, four workplace pension providers.
- The CPA will establish minimum standards for service delivery and product features required of all providers, including default savings funds.
- Employees will be automatically enrolled with the CPA by their employer when they start work.
- Employees (rather than employers) will be responsible for choosing a provider and a savings fund option. If they do not choose, they will be automatically allocated to the default fund of one of the four providers on a carousel basis.
- The register of providers will be reviewed after every ten years, with a new invitation to tender issued.

Based on an assumption of between 80% to 95% consolidation arising from use of a lifetime provider model:

- Total annual master trust provider costs could reach between £680m and £730m by 2035, compared to £1bn under the baseline.<sup>59</sup>
- Total annual master trust member charges could reach between £920m and £960m by 2035, compared to £1.2bn under the baseline (Chart 2.8).
- Total master trust pots could reach 12m by 2035 (9m, active and 3m deferred), compared to 36m under the baseline.

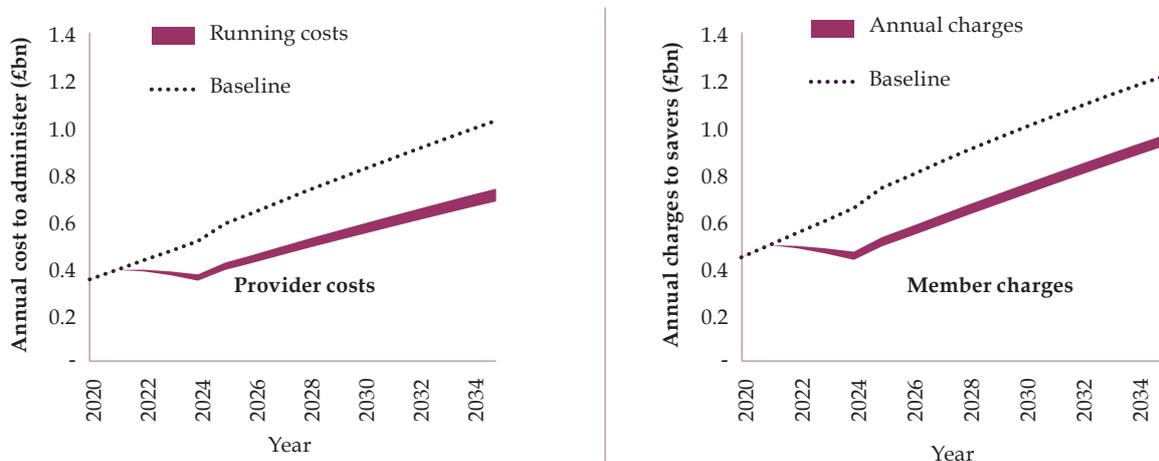
58 Government of Ireland (2018)

59 The modelling assumes that investment charges remain the same for schemes, as these are not pot size dependent, but that admin costs are reduced through pot consolidation.

Chart 2.8<sup>60</sup>

**Lifetime providers could reduce annual saver charges from £1.2bn to £920m and provider costs from £1bn to £680m, by 2035**

Annual aggregate member charges and provider costs of managing pots among master trust schemes by year, 2020 earnings terms



**A default consolidator ensures that those who frequently start and stop contributions are less likely to have pots transferred prematurely**

A default consolidator involves members electing or being defaulted into a consolidator scheme, chosen from a selection of existing schemes. On a member’s pot being deferred for one year, the pot is moved into the consolidator scheme, though members are notified prior to the transfer and can opt out if desired. This policy is intended to ensure those who may take multiple jobs over a short period or move in and out of working, are able to re-join deferred pots before they are transferred to their consolidator provider. The default consolidator model caters to the working patterns of those in the automatic enrolment target group in a way which the other models do not, as this model

avoids some portion of unnecessary transfers for those who are likely to re-join schemes which they already have a pot in.

This analysis assumes that 10% of those with deferred pots either re-join their pots before a year has passed or choose to opt out of their transfer. Based on an assumption of between 60% to 80% consolidation arising from the use of a default consolidator model:

- Total annual master trust provider costs could reach between £730m and £810m by 2035, compared to £1bn under the baseline.<sup>61</sup>
- Total annual master trust member charges could reach between £960m and £1bn by 2035, compared to £1.2bn under the baseline (Chart 2.9).
- Total master trust pots could reach 17m by 2035 (9m active, 8m deferred), compared to 36m under the baseline.

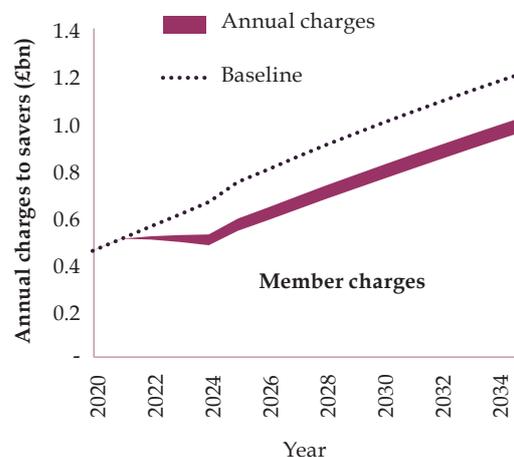
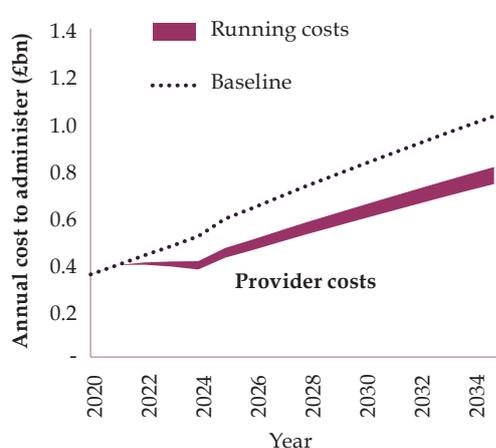
60 PPI modelling

61 The modelling assumes that investment charges remain the same for schemes, as these are not pot size dependent, but that admin costs are reduced through pot consolidation.

Chart 2.9<sup>62</sup>

### Using default consolidators could reduce annual saver charges from £1.2bn to £960m and provider costs from £1bn to £730m, by 2035

Annual aggregate member charges and provider costs of managing pots among master trust schemes by year, 2020 earnings terms



The lifetime provider and default consolidator models could result in some schemes receiving a competitive advantage

While the lifetime provider and default consolidator models are extremely effective in tackling the problems associated with small pots, these models could result in some schemes receiving a competitive advantage, if, for example, they are chosen more often simply because they are more likely to be the first scheme an employee is automatically enrolled into. Particular schemes, such as those which serve a specific industry or market themselves to particular employers could benefit from this advantage.

The introduction of one of these models may increase provider competition for becoming the first scheme used for automatic enrolment and may shift the focus from providing a good quality scheme to marketing for business. In Australia, where members have more choice over provider, there are concerns regarding the level that large Superfund schemes are spending on marketing and other publicity-related activities;<sup>63</sup> around AU\$400m over the past five years.<sup>64</sup>

Consideration of the process of choosing a lifetime scheme or consolidator will need to be carefully conducted in order to ensure that this policy does not result in unintended negative consequences. One option would be to allocate

members to a lifetime provider or consolidator scheme from an approved list, ensuring that no one scheme is given undue advantage. An authorisation scheme could be used to determine which schemes could be on the list. Existing members who are already saving could remain with their current provider, so as to not result in too much transferring at policy inception.

Scheme opt outs, or limiting policies to particular scheme types, might be necessary

The relationship between employer and scheme varies:

- Some employers hold direct responsibility for good quality, trust-based DC schemes, run on behalf of their employees, and may be unable to accept transfers in and unwilling to allow transfers out.
- Some employers have existing bespoke pension arrangements with specific providers with whom they have a long-standing relationship which allows for fee negotiation or the use of specific investment pathways that may not be available in other default strategies.

62 PPI modelling

63 Such as sports sponsorship

64 The Australian, 19 February 2020, Michael Roddan, "Superannuation funds in \$400 million message"

- Some employers provide pension communications and workshops, delivered via the provider, that may not be possible to deliver with employees in many different schemes. Some also offer insurance (for example, life or disability assurance) alongside their pension offering.

Therefore, some form of scheme opt out, or limiting policy coverage to certain schemes (such as master trusts) may be required in order to ensure that employees are not transferred out of schemes in which the benefits outweigh the potential drawbacks of being a deferred member.

### **Most consolidator models carry the danger of encouraging “cherry picking” by schemes**

While automatic enrolment resulted in some schemes “cherry picking” employers who appeared to offer the most profitable set of members, consolidator schemes could result in schemes vying for the pots of individual members,<sup>65</sup> whose income and contributions appear to offer the most in long-term profit. There would need to be serious attention paid by policymakers to the potential for “cherry picking” in order to ensure that large numbers of members with lower incomes are not disadvantaged through mainly saving in schemes which many of the most “profitable” members have left.

### **The potential impact of any of the above policies on the marketplace and employers needs to be taken into account before decisions are made**

Judging solely by the impact on member pots, member charges and provider costs, the lifetime provider and pot follows member models are

the best policies to choose. However, both of these policy models are likely to increase the administrative burden on employers and the lifetime provider model would require significant systemic change and could result in some schemes receiving a competitive advantage. As with all these policies, there will be trade-offs to consider. Consideration by policymakers will need to involve all of the potential trade-offs associated with each model and how policy levers may mitigate potential negative outcomes.

### **Conclusion:**

**As all policies have potential benefits and drawbacks, a combination of policies may be helpful going forward**

All policies involve trade-offs and some present potential market difficulties such as giving particular schemes a competitive advantage or encouraging cherry picking of members who appear most profitable. A policy model which combines aspects of several of these, including the use of dashboards, could help reduce the number of small pots without giving undue advantage or disadvantage to any particular scheme or member. It is worth industry and policymakers reflecting on a model, or a combination of models, which highlight the potential benefits attached to the models discussed in this report but contain functionality which reduces the potential for disadvantages.

<sup>65</sup> [www.accountingweb.co.uk/community/industry-insights/insurers-cherry-picking-employersstaging-auto-enrolment-shock](http://www.accountingweb.co.uk/community/industry-insights/insurers-cherry-picking-employersstaging-auto-enrolment-shock); [www.ftadviser.com/2015/08/24/pensions/personalpensions/providers-not-open-for-sme-auto-enrolment-business-BgA91TYsqDkkbuQ32hznzEI/article.html](http://www.ftadviser.com/2015/08/24/pensions/personalpensions/providers-not-open-for-sme-auto-enrolment-business-BgA91TYsqDkkbuQ32hznzEI/article.html)

# Modelling Appendix

The modelling for this report involves the projection of Defined Contribution (DC) pension saving of the master trust industry considering both an individual's outcomes and the outcomes of the industry in aggregate. There have been a number of simplifying assumptions around the pension industry which are outlined below, and the baseline scenario assumptions are used except where stated explicitly in the report. The application of the policy interventions is outlined below.

## Key reported metrics

Where figures are taken from a stochastic projection the median outcome from all of the scenarios is presented. A range of outcomes may be presented to reflect upon the uncertainty in the projection, particularly where they are subject to unknowns and potential behavioural responses.

### Number of pots

The total number of pots associated with the master trust market is split between active and deferred pots. This does not cover the entire DC market; however master trusts are assumed to account for 80% of enrolments into a DC workplace pension scheme and can be considered indicative of the automatic enrolment DC marketplace.<sup>66</sup>

### Current fund value

This is the current fund value of a member's individual pots. It is presented in current (2020) earnings terms.

### Pension wealth at retirement

This is the total value of an individual's pension wealth at State Pension age allowing for contributions, investment growth and charges. It is presented in current (2020) earnings terms.

### Annual costs

This is the annual cost to the provider to administer the pension scheme. It includes all costs associated with the running of the scheme including administrative expenses, investment fees (generally paid to an investment manager) and other costs associated with the business such as servicing debt. It is presented in current (2020) earnings terms.

### Annual charges

This is the annual charge paid by the member to the provider. It is presented in current (2020) earnings terms.

## Assumptions: pension scheme membership

### Starting conditions

The number and size of pots in 2019 is based upon the trustee and other financial reports of major master trusts in the UK. Where reported figures are not available for particular providers industry averages have been assumed. These figures are aligned with The Pension Regulator's own published data on the master trust market.<sup>67</sup> This identifies the number of active pots, the number of deferred pots and the funds under management. The publications sourced are shown in the table below:

<sup>66</sup> Silcock et al. (PPI) (2019)

<sup>67</sup> TPR (2019)

Appendix Table 1: Publications used for PPI modelling

Master trust provider	Publications sourced
NEST	NEST Scheme Annual Report and Accounts 2016/17, 2017/18, 2018/19 NEST Corporate Annual Report and Accounts 2016/17, 2017/18, 2018/19
The People's Pension	The People's Pension Scheme Annual report and Financial Statements 2017/18, 2018/19 B&CE Holdings Limited Annual report and Financial Statements 2016/17, 2018/19
NOW: Pensions	NOW: Pensions Trust Annual Report and Financial Statements 2016/17, 2017/18, 2018/19
Smart Pension	Smart Pension Limited Financial Statements 2018/19
Legal and General	Legal & General WorkSave Master Trust (RAS and Non-RAS) Annual Report 2018/19

### Projection

The number of active pots is assumed to grow in line with the working age population. This is assumed to be from age 22 to State Pension age (SPa) initially, and from age 18 to SPa from 2025, assuming that the recommendations of the automatic enrolment review are enacted. This implicitly assumes that opt-out rates continue to remain steady and that the portion of workplace pensions serviced by master trusts is steady.

- Working age population projections are taken from the ONS.<sup>68</sup>
- Steady opt out rates is based upon experience observed by DWP.<sup>69</sup>

The number of deferred pots is assumed to increase to three times the number of active pots by 2035. This reflects the size of the provider market and job churn amongst the workforce.

### Assumptions: Cost base

The cost of administering schemes each year is based upon the total costs incurred by providers and reported in their accounts [Appendix Table 1], alongside confidential interviews with the providers and regulator including validation of these assumptions. The assumptions used were:

- Investment related expense of 0.15% of assets under management

- Additional administrative costs of £19.80 per active pot per year and £13.00 per deferred pot. These costs are assumed to increase in line with projected earnings (taken from OBR determinants<sup>70</sup>).

### Assumptions: Charging structures

For simplicity a uniform charging structure has been applied. This consists of an annual management charge (AMC) and an additional fixed charge. This structure reflects the current state of the market (most large master trusts charge a combination of a fixed fee and AMC), with the notable exception of NEST which charges a contribution-based fee instead of a fixed fee. The charge is therefore representative of the market and is not intended to reflect any particular provider.

#### Annual Management charge (AMC)

- The Annual Management Charge is set at 0.25% of the fund value.

This is calculated based upon the funds under management (in the case of aggregate projections) or against the size of the pot (individual projections)

#### Fixed fee

- The fixed fee is set at £20 a year in 2020 and is assumed to increase in line with prices.

Prices are assumed to increase in line with CPI (taken from OBR determinants<sup>71</sup>).

68 ONS (2019)

69 DWP (2020)

70 OBR (2020)

71 OBR (2020)

## The individual modelled

To illustrate the impact that alternative deferred pot policy scenarios could have on an individual, a vignette illustration of outcomes has been prepared based upon the following life-course features:

### Earnings

The individual is assumed to be a low earning employee earning at the 30<sup>th</sup> percentile of full-time male earnings throughout working life. Earnings are age and gender specific and are derived from Labour Force Survey data.<sup>72</sup> Earnings levels are assumed to increase in line with projected Average Weekly Earnings (taken from OBR determinants<sup>73</sup>). Median long-term earnings growth is assumed to be 3.8%.

### Pension scheme membership

Total pension contributions, split between the individual and their employer, are assumed to be 8% of gross earnings every year from age 18 until retirement at age 68 (in line with SPa).

They are assumed to move between 9 roles and pension pots across their working life, changing job more frequently at younger ages:

- 1<sup>st</sup> pot starting at age 18 (1 year of contributions)
- 2<sup>nd</sup> pot starting at age 19 (1 year of contributions)
- 3<sup>rd</sup> pot starting at age 20 (1 year of contributions)
- 4<sup>th</sup> pot starting at age 21 (2 years of contributions)
- 5<sup>th</sup> pot starting at age 23 (5 years of contributions)
- 6<sup>th</sup> pot starting at age 28 (10 years of contributions)
- 7<sup>th</sup> pot starting at age 38 (10 years of contributions)
- 8<sup>th</sup> pot starting at age 48 (10 years of contributions)
- 9<sup>th</sup> pot starting at age 58 (10 years of contributions)

## Fund returns

Fund returns are based upon an asset portfolio generating returns. The central rates of return are based upon the determinants taken from the Office for Budget Responsibility's (OBR) Economic and Fiscal Outlook (EFO)<sup>74</sup> (for both short-term and long-term assumptions).

Individual modelling has been undertaken stochastically by applying Monte Carlo simulation. This is using the PPI's Economic Scenario Generator to project the distribution of inflation and returns under uncertain future economic conditions.

Aggregate modelling has used a deterministic approach consistent with the central returns under the individual stochastic modelling.

### Asset allocation

Assets are assumed to be invested in a representative portfolio consisting of: 60% of assets in equity; 40% of assets in debt/bonds.

### Investment returns

The median long-term returns were aligned to the long-term determinants used by the OBR.

Investment returns are modelled stochastically with curves generated by the PPI's Economic Scenario Generator (ESG). 3,000 scenarios were produced providing values for equity returns, bond returns, cash returns, CPI and earnings increases each year for each scenario. The median long-term fund returns generated using this approach is 5.84%.

### The Economic Scenario Generator

The PPI's Economic Scenario Generator (ESG) is used to produce randomly generated future economic scenarios based upon historical returns and an assumption of the median long-term rates of return. It was developed by the financial mathematics department at King's College London. It is used to test how the distribution of outcomes is influenced by the uncertainty of future economic assumptions.

72 ONS (2020)

73 OBR (2020)

74 OBR (2020)

### Key results

The model generates projected future inflation rates, and earnings growth:

- Inflation rates: future CPI increases and earnings inflation rates.
- Investment returns: returns are produced for the major asset classes of equity, cash and gilts.

This produces nominal returns which can be combined to produce investment returns for a more complex portfolio.

### Application of output

The output of the ESG is a number of economic scenarios which are employed by the PPI's other models to analyse the distribution of impacts on a stochastic economic basis.

### Key data sources

The specification of the model is based upon historical information to determine a base volatility and future assumptions to determine a median future return:

- **Historical returns:** Historical yields and returns as well as inflation measures are used to determine the key attributes for the projected rates;
- **Future returns:** Future returns are generally taken from the OBR EFO to ensure consistency with other assumptions used in the model for which the economic scenarios are being generated. Volatility can also be scaled against historical levels.

### Summary of modelling approach

The six identified risk factors modelled are:

- G Nominal GDP
- P CPI
- W Average weekly earnings
- Y<sup>l</sup> Long-term yields
- Y<sup>s</sup> Money market yields
- S Stock returns

Using these variables, a six-dimensional process,  $x_t$  is defined.

$$x_t = \begin{bmatrix} \ln G_t - \ln G_{t-12} \\ \ln(P_t - \ln P_{t-12} + 0.02) \\ \ln W_t - \ln W_{t-12} \\ \ln(e^{Y_t^l} - 1) \\ \ln(e^{Y_t^s} - 1) \\ \ln S_t \end{bmatrix}$$

Where t denotes time in months.

The development of the vector  $x_t$  is modelled by the first order stochastic difference equation:

$$\Delta x_t = Ax_{(t-1)} + a + \varepsilon_t$$

Where **A** is a 6 by 6 matrix, **a** is a six-dimensional vector and  $\varepsilon_t$  are independent multivariate Gaussian random variables with zero mean. The matrix **A** and the covariance matrix of the  $\varepsilon_t$  were determined by calibrating against the historical data. The coefficients of **a** were then selected to match the long-term economic assumptions.

It follows that the values of  $x_t$  will have a multivariate normal distribution. Simulated investment returns will, however, be non-Gaussian partly because of the nonlinear transformations above. Moreover, the yields are nonlinearly related to bond investments.

The first component and third components of  $x_t$  give the annual growth rates of GDP and wages, respectively. The fourth and fifth components are transformed yields. The transformation applied ensures that the yields are always positive in simulations. Similarly, the second component gives a transformed growth rate of CPI. In this case, the transformation applied ensures that inflation never drops below -2% in the simulations. This figure was selected to be twice the maximum rate of deflation ever found in the historical data.

## Alternative policy scenarios

The assumptions used to assess the impact of policies are particularly sensitive to certain factors which are expected to evolve. This includes:

- The number of master trusts in the market and their market share
- The number of individuals exiting the master trust market
- Behavioural influences (or compulsion) and engagement with pensions

The impact of these factors upon the assumptions for modelling the alternative policies modelled are discussed below:

### Dashboards

The **individual vignette modelling** assumes that pots are accumulated as in the baseline until 10 years before retirement (age 58) whereupon all deferred pots are combined into a single active pot which is maintained until retirement age at age 68. This reduces the weighted number of pots in the lifetime of the individual by 24% (deferred pots are reduced by 28%).

In **aggregate projections** there is a great deal of unknown behavioural response, with the potential for individuals to consolidate pots at a younger age, however, the impact is expected to be hampered by low coverage and low engagement. A range of outcomes has been modelled assuming that the aggregate reduction in deferred pots is in the range 10%-30%.

### Same provider consolidation

In **aggregate projections** this will reduce the cost associated with administering an individual's pension pots to a provider as it is assumed that simpler record keeping would be applied. Due to the small number of large master trusts and the association they have with particular sections of the labour market<sup>75</sup> it is likely that particular individuals find themselves repeatedly returning to the same providers with different employers. Based on this association and the small number of large providers it is assumed that this could result

in a reduction of between 20% and 50% of deferred pots. However, due to the treatment of records by different providers and significant uncertainty in the assumptions the range of outcomes presented is wide.

### Pot follows member

The **vignette modelling** member's pension moves with them to the new employer's scheme. The individual model combines the fund generated from the previous pot to the new, active pot. As a result, they have a single pension pot throughout working ages cutting their weighted average number of pension pots by 85%.

In **aggregate projections** allowance has been made for an opt-out of this process as well as those who leave the master trust market before retirement. This is for a number of reasons – early exit of the labour market or joining a part of the labour market outside of normal master trust market (e.g. public sector or self-employed). These factors combine to give an aggregate reduction in deferred pots is in the range 70%-90%.

### Member exchange

The **aggregate projected** impact upon this policy is uncertain to project. Trustees attitudes towards the potential value for money to individuals of being transferred may hamper the policy. With providers altering their charging structures over time there may be issues around the timing of transfers. It is therefore assumed that maybe half of all potential transfers may actually take place, which alongside those deferred pots that will have no corresponding pot with another provider may only reduce the number of deferred pots by 40%-60%.

### Lifetime provider

Election of a lifetime provider ensures that the **individual vignette** remains with the same provider throughout their working life, with each subsequent employer making contributions to the same, elected, scheme.

75 PPI interviews with providers

In **aggregate projections** this would have the greatest effect as employers would not be able to refuse their employees' pension nomination and as an idealised result all individuals would only maintain one pot throughout their life. Deferred pots would still exist when an individual exits the master trust provider market or opts out of such a process, however, it is estimated that this may result in an 80% to 90% reduction in deferred pots.

#### Default consolidator

A default consolidator approach would operate in a similar manner to a lifetime provider, however, rather than maintain a single active pot, each individual would maintain a single active pot and a single deferred pot. However, in instances where these coincide (an employer uses an employee's default consolidator as their

pension provider) an individual would have a single pot. Based on individual's exiting the market and the maintenance of only a single potential deferred pot for an individual it is estimated that this could cut the number of deferred pots by 60% to 80%.

#### Alternative charging scenarios

Additional individual pot projections were made using the following charging structures to understand the impact of charges upon a small, deferred pot (£100, £500, and £1,000):

- A scenario with no charges
- Annual Management Charges of 0.5% of the fund value
- A fixed fee of £24 per annum

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