Addressee

smallpots.callforevidence@dwp.gov.uk
Small Pots Policy Team
Department for Work and Pensions
Caxton House
Tothill Street
London
SW1H 9NA

Lane Clark & Peacock LLP

St Paul's House
St Paul's Hill
Winchester
SO22 5AB

BY EMAIL ONLY

Dear Small Pots Policy Team

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Addressing the challenge of deferred small pots – LCP's response

Introduction

We welcome the opportunity to respond to this Call for Evidence about the challenge of deferred small pots. This issue has been known about for several years and is overdue a solution. We appreciate the difficulties of finding a solution, or solutions, to this but we hope that you will now act quickly to implement processes to manage the challenge, noting that the more it is delayed, the bigger the problem gets.

Who we are

LCP is a firm of financial, actuarial, and business consultants, specialising in pensions, investment, insurance, energy, health and business analytics. We have around 1,000 people in the UK, including 160 partners and over 300 qualified actuaries.

The provision of actuarial, investment, covenant, governance, pensions administration, benefits advice, and directly related services, is our core business. About 80% of our work is advising trustees and employers on all aspects of their pension arrangements, including investment strategy. The remaining 20% relates to insurance consulting, energy, health and business analytics. LCP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.

We are content for our response to be quoted in a future government response.

1. Do you agree that these are the appropriate key criteria to inform development of a market-wide small pots consolidation solution? Are there additional/different criteria to apply?

We broadly agree with the criteria, however we make two points:

- When assessing any potential solutions against the third and fourth criteria of supporting a "more efficient workplace pensions market" and "minimising complexity and administrative burdens for employers", it should be borne in mind that any solution is likely to lead to a substantial resource drain on providers, and possibly employers, whilst it is bedded in.
- Assessment against the fifth criteria of commanding "confidence in the system for savers and tax-payers" should include consideration of protection against scams and also mechanisms for opting-out of, or rolling back, unwanted or unintended automatic transfers. Some savers may not want to consolidate their small pots because as a result they might lose their options to entirely cash out their pot, for example. Additionally, it should be noted that the standard of data matching for actually moving money around without consent needs to be even higher than that which will be required for displaying data on Dashboards.

2. How do you think we can increase member-initiated consolidation and what are the opportunities, risks, and limitations of member-initiated consolidation?

As you have noted, the implementation of Pensions Dashboards is intended to improve savers' interactions with their pensions. However, Dashboards are still several years away from being available to the general public (and longer still following the government's announcement of 2 March 2023 of a delay).

Despite this, we do not think there should be further initiatives to increase member-initiated consolidation for several reasons. We do not think that any such initiatives are likely to lead to a material increase in consolidation but are concerned that any such campaigns might lead to inappropriate consolidation not in the best interests of savers as they could be pressured into poor choices. And then there will be chance of blame being placed on the employer, trustee, provider or even government who advertised this to the saver.

3. We would be keen to understand from respondents, how far do you believe market innovations can go in reducing the growth of deferred small pots?

As you noted, the ABI and PLSA set up the Small Pots Cross-Industry Co-ordination Group in March 2021 at the government's request. We believe that this group effectively explored how far market innovations could reduce the growth of deferred small pots, and we do not believe these will lead to significant reduction.

4. Do you consider one of the values below to be the most appropriate starting limit for eligibility for automatic consolidation, and why – or is there an alternative value? a) £1,000 b) £2,500 c) £5,000 d) £10,000

When Pot follows Member was first discussed about 10 years ago, the ambition was that this should apply to pots up to £10,000. However, since that time, the pensions landscape has significantly evolved, and we believe that there are arguments for a lower limit.

There is a tension here between setting a high-enough limit that will lead to material cost-savings for providers (which should indirectly benefit savers as well) versus setting a limit that is too high for savers to feel comfortable with their funds being automatically transferred versus making sure that the results of any automatic consolidation are pots that savers feel are meaningful and will have a positive impact on their retirement.

On balance, we feel that a limit of £5,000 would be acceptable, although we would favour a staged approach to this implementation with the possibility of stopping at a lower level if the post-implementation evidence shows that a lower limit has achieved the policy aims.

5. How many deferred pots does your scheme have within each of the above breakdowns, how many of these are within AE charge capped default funds, and what is the total AUM of deferred pots for each of these breakdowns?

N/A

6. What is the average cost of a pot transfer (ceding and receiving) for your scheme, within AE charge capped default funds?

N/A

7. Would the increase in pot transfers associated with an automated small pots solution affect your investment strategy? If so, how, and why?

N/A

8. What is the average cost of administering a pot for your scheme, does this differ by active/deferred, or by size? If so, what is the difference in costs and why?

N/A

9. What is the breakeven point for administering pots for your scheme, does this differ for active/deferred pots?

N/A

10. Do you think there should be a minimum pot size limit for pots to be eligible for automatic consolidation? If so, what do you think this limit should be, and what should happen to pots below that limit?

We are pleased that you have re-opened the question of refunds of micro pots. We support this in principle since we do not believe that even combining several micro pots together will materially affect a saver's retirement outcome (eg even 10 micro pots of £100 still only sum to £1,000) and the costs of administering these micro pots are disproportionate.

We also believe that when setting pricing for schemes, providers partially base this on the expected rate of turnover at a company and that higher turnover leads to higher pricing. So, it is possible that permitting refunds would lead to lower pricing being set, thus improving member outcomes.

However, the details of the refund mechanism are key. We can foresee that most savers would have little concern if a pot of less than £100 was refunded to them and would appreciate receiving it as a cash sum. However, there were problems with the "old" refund rules in two areas:

- Eligibility for refunds was based on length of service. That should not be the case and it should purely be determined by pot size.
- Employer contributions were not included in refunds to employees, and this could lead to poor outcomes for members, such as if they contributed through salary sacrifice and then left service after a short period of employment. The salary sacrifice rules meant that effectively they could have given up a percentage of their salary and received <u>no benefit at all</u> for doing so. Even if employees received a refund of their own contributions there would often be resentment – particularly from DC members – that they did not benefit from the <u>employer</u> contributions that they thought had been made on their behalf. Therefore, we suggest that consideration should be given to refund of contributions of up to £250 and that this includes employer contributions as well (or possibly total fund value).

It should go without saying but we expect that the Treasury would want to apply taxation to such refunds.

11. Do you agree that setting a prescribed period for a pot to be classified as deferred is the most appropriate solution – and what period of time would be appropriate, and why? If not, what would be a more suitable approach?

Yes, we agree. A period of one year should cover most legitimate cases but consideration should be given to a mechanism to reverse an automatic transfer where, for example, it transpires that the saver was on extended sabbatical for whatever reason.

12. Do you agree with the above summary of potential benefits and implications of the default consolidator/s approach, and if not why?

We agree with your summary.

13. What are the key benefits / risks of a multiple default consolidator and single default consolidator approach, including impacts on the wider pension market, and employers?

We are pleased that you have re-opened the possibility of a single default consolidator. We recognise the potential for distortion and impact on competition that such an approach could bring but, considering that one of the reasons that the industry has called for a solution to small pots is because they are costly to administer, if a consolidator model is to be the solution, then a single consolidator, which has government backing, is worthy of serious consideration.

We have concerns that a multiple default consolidator model has little benefit for savers due to the asymmetry of knowledge when choosing which consolidator to join.

We also think it is likely that commercial consolidators will try to cherry-pick more profitable savers (albeit by definition each individual pot will be small in value) and leverage the consolidation into persuading the saver into further, possibly unsuitable services also provided by the consolidator.

14. Who should be able to be a consolidator; should there be a limited number, and, if so, how many, and why?

It follows from the above that if there is to be a default consolidator then we would favour a single government-backed consolidator. Nest would be the obvious candidate to take on this role since it is already in operation and is a known and recognised name for pension provision. Alternatively, a new (non-commercial) vehicle for this consolidation role could be created, in which case a tender process could be followed.

However, if a multiple consolidator model is pursued then this must lead to full and fair competition, with no limitation on numbers, but a requirement for rigorous authorisation, similar to master trusts.

15. What would be the appropriate approach to giving members choice in terms of choosing their consolidator, and what approach should be taken if the member did not make an active choice?

This question goes to the heart of the matter of our concerns about multiple default consolidators. We do not believe that many members will be engaged enough to choose a consolidator, and of those that are, it is doubtful that they will have sufficient knowledge to make an informed decision and instead are more likely to be swayed by, for example, a slick TV advertising campaign. Therefore, for a multiple consolidator model, this leads us to reluctantly conclude that either the consolidator should be linked to the saver's first employment, and probably chosen by their first employer – but that then effectively ties the saver "for life" to that consolidator chosen by that employer. Alternatively, savers could be allocated a provider at random – the carousel system you refer to – but that then will lead to future complaints when one provider underperforms another as will inevitably occur.

16. Do you agree with the above summary of potential benefits and implications of the pot follows member approach, and if not why?

We agree other than your view that there is a risk to members reaching the maximum pot value limit relatively quickly and the pot becoming "stuck". If the maximum limit is set at a meaningful limit then this should not be a concern.

17. What are the key benefits / risks of a pot follows member, including impacts on the wider pension market, and employers?

As noted above, the idea of Pot follows Member was first discussed about a decade ago. Therefore, the concept is widely understood in the industry. And one of the major changes since then is major strides that have been made in member identification and matching for Dashboards. Whilst, as mentioned above, the criteria for a successful match needs to be even higher where money is being moved around, this work for Dashboards should be transferrable to Pot follows Member.

Since that time, legislative developments such as the charge cap, improved DC governance and master trust authorisation, have also reduced concerns about savers being automatically transferred into worse schemes.

Pot follows Member will also lead to savers having a lower number of total pots to manage than a default consolidator. We also think it is likely that many savers will be more engaged if their pension savings are consolidated into their current active pension vehicle linked to their employment rather than their past savings being managed "on the side" by a third party that the saver may feel less engage with.

We do recognise that the issue of multiple jobholders is still to be fully solved.

18. Of the two solutions set out above what is your preferred approach, and why?

We note that both approaches are likely to lead to an increased drain on resources for the industry whilst it is set up and, in particular, the current "stock" of small pots are dealt with.

However, as should be clear from our answers above, we favour Pot follows Member.

19. Are there any further / fresh or hybrid solutions that are worthy of consideration?

Again, we refer to the ABI and PLSA set up the Small Pots Cross-Industry Co-ordination Group and the research and analysis done by that group. If there were any further solutions to consider then we think that Group would have already done so.

We believe that the time has come for government to decide a way forward and act to implement a solution, noting that any decision made will still likely take several years to implement.

20. Should there be an initial focus on managing the flow of new pots or removal of the existing stock, and where does the balance of impact lie for each of the solutions presented?

There are good arguments for the initial focus to be on either “flow” or “stock”.

For “flow”, an effective solution that stems the proliferation of new small pots will mean the problem reduces to a quantifiable number of historic small pots.

Balancing that, dealing with “stock” pots first could be easier *because* it is largely a known problem – and mechanisms such as member exchange could potentially make significant headway in the initial stages of this porject. Additionally, the value of “stock” pots is likely to be higher than new “flow” pots and so there may be more interest in dealing with them first. However, it may be necessary to limit automatic solutions for “stock” pots to those which do not have additional complications such as NMPA protections, with-profits or guaranteed annuity rates etc.

Overall, we favour a slight bias towards solving the “stock” problem first.

21. What could be done to incentivise, build momentum, and help build market and member confidence in member exchanges, either now or in future? Would this be best taken forward by industry or government?

You have noted that the issue of NMPA was explored by the Small Pots Cross-Industry Co-ordination Group. We understand that this was a particular concern for member exchange, and we believe that legislative change will be required to effect this.

22. Could a member exchange form part of a hybrid model alongside one of the large-scale consolidation solutions discussed in Section 5, or with a large-scale consolidation solution acting as a backstop?

We think that member exchange, with proper legislative support, could be used in the initial phases of a solution in order to deal with “stock” small pots. This could be particularly helpful for master trusts, including Nest, where it is likely that there will be many overlapping members. But we think member exchange is less important for single employer trusts and if there is a successful solution to dealing with “flow” small pots then member exchange should not be needed in the long-term.

23. Do you agree that same scheme consolidation has a key role to play in the wider consolidation of deferred small pots, and can act as a foundational measure to larger market-wide solutions? If not, why?

Yes, we agree with this. However, this measure may require some providers to significantly update their IT and administration systems to enable records to be linked.

24. If your scheme currently does not undertake same scheme consolidation, what are the reasons behind this and what would be required to overcome this?

N/A

25. As part of this call for evidence we would therefore welcome views on how protected groups are currently impacted by the deferred small pots issue;
a. whether the impact differs between groups and in comparison, with non-protected groups;
b. what mitigations providers are putting in place and the impact of each of the options on protected groups; and
c. and how any negative effects arising from them may be mitigated

Although not a protected group, it is likely that any policies in this area will have a greater impact on lower paid individuals and decisions which are made should reflect this.

Conclusion

We hope that our comments will be helpful to you when deciding how to tackle the problem of small pots proliferation. We are happy to discuss any of these points further with you.

Yours faithfully

By email only 15.00 27 March 2023

Laura Myers
Partner and Head of DC

+44 (0)20 7432 6639
Laura.Myers@lcp.uk.com

Tim Box
Senior Consultant

+44 (0)1962 872739
tim.box@lcp.uk.com

About Lane Clark & Peacock LLP