LCP powering possibility

The Lifetime Provider Call for Evidence Team

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Dear Lifetime Provider Call for Evidence Team

LCP's response to the Call for Evidence on Lifetime Providers

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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, whether DB or DC, 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.

Introduction

We welcome the opportunity to comment on the Call for Evidence about Lifetime Providers and your long-term vision for pension saving in the UK. Unfortunately, we think that there is very limited rigorous data and evidence to make a compelling case for Lifetime Providers and we currently think the Lifetime Provider model is fundamentally flawed. The policy intent behind it is unclear to us but if the primary goals are to reduce the creation of new small pots, increase investment in productive finance and to increase engagement we believe that there are better ways of achieving these goals and would be happy to discuss these with you. We are also unclear in several areas about the specifics of the Lifetime Provider model you envisage, which makes it more challenging to engage constructively, but overall, we believe that any such variant of this model is very unlikely to lead to better outcomes for the majority of pension savers. We therefore believe that you should not pursue this idea and instead focus your resources on current policy changes already in progress. These current policy changes include implementing reform of auto-enrolment contributions, solving the "micropots" problem via multiple default consolidators that starts with large AE providers, improving VFM for pension savers, CDC and successfully launching the Dashboards infrastructure. If these existing issues were successfully completed and do improve saver engagement and outcomes then any need for Lifetime Providers is likely to fall away.

Impact of Lifetime Provider on 'ordinary savers'

Automatic enrolment (AE) has been a great policy success, bringing around 10 million people into pension saving for the first time. The evidence shows that the majority of these people are on low and middle incomes, and we believe that any reform proposal needs to be evaluated in terms of its impact on this group in particular, as higher earners tend to be more engaged and have larger pension pots already, giving them a higher chance of a good pension outcome in retirement.

One way in which AE has benefited those on more modest earnings, and has contributed to a reduction in the gender pension gap, is that employers negotiate favourable terms, at scale, on behalf of their entire workforce. Providers are not able to 'cherry pick' by offering better terms to higher earners, and it is the presence of higher earners in a workplace (and overall assets) which makes the scheme as a whole viable to providers. If higher earners are courted by Lifetime Providers, subject to extensive marketing etc., the danger is that there will be an exodus of contributions from those at the top, fundamentally changing the quality of schemes for those who are left. We provide evidence in question one of the way in which providers are already willing to offer better terms for the pensions of corporates that have more high earners in order to secure the business. We see this as a clear foretaste of the potential adverse consequences for 'ordinary savers' if top earners opt out of their existing workplace pension scheme.

Diversion of regulatory and legislative activity from higher priorities

The number one priority in workplace pensions should be to get more money going in. Other issues such as small pots/ lost pots etc. do have an impact, but the bigger issue is that millions of people are simply not saving enough. DWP has limited resources to progress legislative and regulatory reform and there is a real danger that a flurry of reform initiatives means that the big prize – implementing the existing proposed reforms to auto-enrolment and the necessary next steps – is already being delayed. It is worth noting that some of the 'problems' which the Lifetime Provider idea is aiming to solve such as 'lost pots' should be largely addressed by pensions dashboards, as members can see their pots and transfer them. Furthermore, a member who simply has a deferred pot with a large master trust may not be 'losing out' in any meaningful way in the short term, as their money continues to be well managed and invested on their behalf. The 'problem' of under-saving is much more pressing.

It also appears that in parts of your Call for Evidence, such as in paragraph 119, there is a subtext that Lifetime Providers will unlock the potential for more investment in illiquid assets. But we do not think this exclusively applies to Lifetime Providers and that there is more potential for investment in illiquid assets in the current system, which we see starting though the positive introduction of LTAFs and will be furthered though the focus on value for money.

Comparisons with Australia

Your Call for Evidence refers to the recently introduced "stapling" model in Australia as an example of a possible Lifetime Provider model and Australia is often cited by other commentators as an example of how the UK DC pensions landscape could evolve. However, we point out in the context of this Call for Evidence that the Australian pension industry is much more consolidated, is benefiting from 30 years of mandatory contributions, leading to much larger pots, and has much less complex legacy history to it. So what works for the relatively straightforward Australian pension landscape may not successfully transfer to the UK. The Australian system also has some weaknesses to it. For example, we have heard from our Australian contacts that often new employees "can't be bothered" to find their existing superannuation details to provide to their new employer, or do not wish to be seen as being "disloyal" to their new employer by asking for their pension contributions to be paid to an arrangement linked to a previous employer. Additionally, we understand that a significant number of savers choose their own investments in Australia – that can lead to worse long-term outcomes if individuals choose poorly. And it is easy to predict that happening in the UK by analogy with the ISA market where it is known that many savers choose a Cash ISA over a Stocks ISA despite the likelihood that a Stocks ISA will perform better in the long-term. Finally, we understand that marketing costs can average around 25% of all scheme costs, and this leads to upward pressure on member charges.

Scope of 'choice'

There is much talk of 'member choice', but we are unclear how wide member choice would actually be under these proposals. Paragraph 127 states that: "for example by requiring employers to accept an employee's request to pay contributions into a workplace pension scheme into which they have previously been enrolled". But is it really your intention that employers would be required to accept into their own Single Employer scheme contributions from ex-employees? Your wording suggests that employees would only have the right to request pension contributions to be paid into a pension scheme linked to a previous employment and hence would exclude non-employment linked pension arrangements. We ask for confirmation that this is your intention since we find it very hard to envisage a

pensions landscape where employers will be content to accept contributions into their own scheme from ex-employees and do not see how this will lead to better outcomes for savers.

It may be you envisage that Master Trusts will all become Lifetime Providers - Paragraph 132 states “It is already the case that 95% of savers in trust-based market are within around 30 Master Trusts”. But there is not homogenous pricing even within the same Master Trust: For example, “Frozen Foods plc” and “SuperShopping Ltd” do not necessarily pay the same charges despite both being with “Master Trust X” with the same services and investments. Is it your intention that a saver who changes employment from one of these to the other will be able to require their contributions to be paid to Master Trust X under the label of whichever employer has been able to negotiate the better terms?

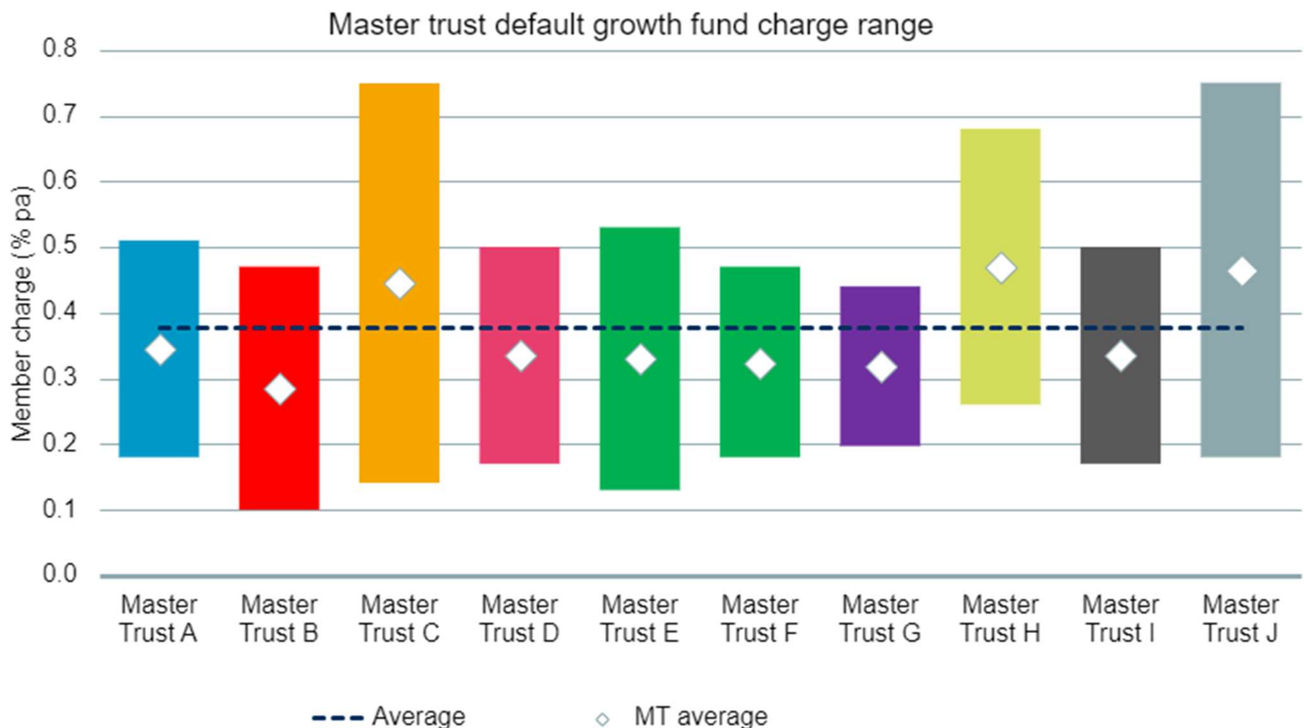
Setting aside the above uncertainty for now, if in Phase 1 (the ‘member choice’ phase), employees would be restricted to staying with the current employer offering or paying into a scheme they have previously been part of. If so, it would be something of a lottery which providers had been chosen by previous employers, yet that would determine the range of ‘choice’ open to members. In Phase 2 (‘Lifetime Provider’/ stapling), member choice appears to be restricted to the current employer offering or the initial/ Lifetime Provider. However, once the ‘choice’ genie is out of the bottle, it is hard to imagine there would not be pressure (especially from the most engaged savers) to allow contributions to be directed to a SIPP or similar, held on an investment platform. Whilst this could lead to considerable competition between investment platforms, there is a world of difference in terms of underlying investment of the pension assets between a SIPP – potentially spread across dozens of funds on the investment platform – and a large Master Trust default fund, perhaps following the Mansion House principles, taking account of ESG objectives etc.

In short, either the extent of ‘member choice’ is extremely constrained (and hence competitive pressures potentially very limited) or it is much more extensive which could lead to big issues about consumer protection and about fragmentation – which goes in the opposite direction to current government policy.

1. What are the key considerations to take into account before deciding the process to implement a lifetime provider model and what elements would need to be in place?

- The overriding consideration has to be whether this will improve the **majority** of member outcomes. We ask what evidence is there that allowing individuals to direct their employer pension contributions will achieve this. We are deeply concerned that this proposal could lead to a virtual re-run of the pensions mis-selling scandal of the late Eighties/ early Nineties where millions of employees were encouraged to opt-out of employer-sponsored plans with disastrous consequences both for themselves and for confidence and trust in the pensions industry itself. We also note that DB pension schemes are still held up as the “gold standard” for UK pension savings and yet such schemes give barely any choice or options for members. This is the opposite of what the Lifetime Provider proposal sets out to do.
- Following on from this, another key consideration has to be the impact these proposals would have on “average” workplace pension savers who may well not engage or switch. This is the group for whom auto-enrolment was set up for (and has brought millions of savers into the pensions system) and they should be at the centre of any reform. As a result of auto-enrolment, most workers now benefit from an employer negotiating a good value, low-cost pension for the entire workforce. If, as seems likely, higher earners and those with larger pension pots are targeted by pension providers and are the most likely to be engaged and actively choose to re-direct their contributions, this could fundamentally alter the economics of the workplace scheme for the remaining employees, leaving them with poorer value pensions as fees overall increase to cover the costs those with larger pots picked up.
- Workplace pension providers use a number of metrics to determine the charges they will offer to each corporates’ scheme and their members – for the vast majority of pension providers and Master Trusts they offer each corporate pension scheme a bespoke fee based on how attractive the overall business is to the provider/ Master Trust. Obviously, the overall size of the scheme and assets is a factor, but one key factor is tthe average pot per member. This has a major impact on the charges offered as schemes with larger average pots bring more money to the provider (as charges are a percentage of pots) whilst costs – like administration - are likely to be similar across all schemes. We can see this effect with our own clients, giving you two examples: one scheme (an engineering and management consultancy) with c£500m of assets and 7,000 members has an average pot size of c.£70,000 per member, they pay 18bps for a fund, whereas a second scheme (a retailer) again with £500m of assets has c.92,000 members - so £50,000 average pot per member - pays 35bps for the same fund in the same Master Trust – with the exact same services. To provide you with

further evidence of how variable costs can be for exactly the same Master Trust investment strategy and service we asked the largest insurance and consultant led Master Trusts to provide their highest and lowest costs charged to corporates in their standard Master Trust offering, which is illustrated by the chart below (which shows significant range of charges for exactly the same product based on the attractiveness of the corporate's scheme):



- Another consideration is the impact on employer costs and engagement with workplace pension savings – noting that this is likely to differ depending on the size of employer. Although auto-enrolment is a burden on employers, one great advantage is that they are generally dealing with a single pension provider for most of their workforce. There will be considerable hassle if employers have to deal not just with a stay-in/opt-out choice under auto-enrolment, but with employees making choices about individual pension provider, potentially updating and modifying those choices, with providers potentially chasing up queries about contributions etc. etc. Alternatively there would have to be significant central spend on a clearing house to do this, which would obviously need to be funded from somewhere. There needs to be clear evidence of gain to justify this cost to employers, whose money would be better spent paying more money into their workers' pensions. For clarity, we are not saying that this is "too difficult" to do but are instead questioning whether this is the best use of resources to improve saver outcomes. As for employer engagement, some employers (eg banks) may use pensions as a recruitment and retention device and to be brutally honest, this will be to recruit and retain higher paid employees. If these employees are enticed away from the employer's own pension scheme, employers are less likely to see a purpose for providing more than the statutory minimum pension contributions.
- The "first provider" impact also needs to be taken into account. By this we mean that inertia is a very powerful force when it comes to pensions as we have seen with auto-enrolment and also for other financial services such as bank accounts. It is general human nature not to keep such matters under constant review and therefore it can be years or decades before an individual changes a provider. But as you yourselves have stated on many occasions, an uncompetitive charge on pension funds can have considerable impact over a number of years. Therefore, we are concerned that under Lifetime Provider there will be huge competition by providers to attract savers but this battle will be fought through advertising spends and based on "baubles" such as joining incentives or short-term preferential terms rather than competition on true long-term VFM for savers. It appears to us that Lifetime Providers will spend literally millions of pounds on marketing costs and that these will ultimately be passed on to savers via higher charges. As we noted above, in Australia where 'super funds' compete to attract contributions, marketing costs can average around 25% of all scheme costs, and this leads to upward pressure on member charges as the providers are commercial entities and need to recoup costs, and the only way this is done is by passing them to the end user – the saver.

- If Lifetime Providers are introduced, the Government would need to decide what this meant for the current duty on employers to set up a workplace pension. If this duty was to be removed (so that employers simply channelled new contributions to a nominated scheme) this might lead to a 'dumbing down' of provision in workplaces of more paternalistic employers who currently choose to offer high quality pensions, well in excess of the statutory minimum.
- It could be argued that it would be unduly onerous to expect the smallest employers to go on 'setting up' a pension scheme for their one or two employees who might choose to direct their contributions to another scheme leaving an 'empty box' workplace scheme. But one of the strengths of automatic enrolment has been that it is a universal duty, no matter who you work for, and it would be regrettable to undermine this principle.
- The issue of different tax treatment of contributions between relief at source and net pay arrangements needs to be finally solved.
- Whilst a member choice or Lifetime Provider model would address the flow of new contributions, and the 'multiple default consolidator' model would still be needed deal with deferred micro pots, the pensions landscape still has tens of millions of other deferred DC pensions. Even if the Lifetime Provider model was adopted for the flow of new contributions, most people reaching pension age in the coming decades would still do so with multiple, fragmented pension pots. A holistic solution therefore needs to consider the stock of (non-micro) small pots. We therefore suggest that the small pots work is done first, and when consolidation of these pots is undertaken on a regular basis it would also stop the flow of small post in the future.

The elements that need to be in place overlap with the considerations and building blocks in Q3 but we will note here that requirements include:

- the ecosystem – which must not be underestimated. This will need to obviously cover pension administration but also regulation, tax and technology. There are already two new ecosystems either being set-up or proposed, namely for Dashboards and multiple default consolidators. So far, neither of these appear suitable to also cope with the Lifetime Providers proposals so either one of them needs to be extensively redesigned so that it is, or a third ecosystem will be required. Either way, this work will need to be paid for and, if pension schemes and providers have to do so then ultimately that will feed into additional costs for savers.
- a system for creating strong unique IDs will be needed. This is largely self-evident: since actual money will be moved around under Lifetime Providers (unlike Dashboards), there cannot be scope within the system for any ambiguity. However, if the Lifetime Providers system does become a high-volume undertaking then it needs to be as efficient as possible and it cannot afford to have situations where the destinations of potentially millions of payments need to be checked multiple times.
- authorisation and supervision regime – given that master trusts have to be specifically authorised we expect that another regime will be needed to cover Lifetime Providers. Part of the supervision regime will also have to be a mechanism to deal with a failure of either a provider or clearing house (unless this is backed by the government). This will be key as DC pensions savers under this model would be more likely to have all their pension saving eggs in one provider basket – which would cause significant impacts when a provider fails.
- vastly improved general financial education with clear and comparable information about providers readily available to savers. This will obviously take many years to fully achieve, and needs to start in schools, but it will be required if you are expecting individual employees to make sophisticated VFM comparisons between competing providers. Whilst, for example, individuals working in financial services may have some capability for making such comparisons – and even that is not certain – the majority of workers in, for example, healthcare, hospitality, construction and retail industries are likely to be ill-equipped to make such choices and you make effectively this same point in paragraph 149. We also believe that a Lifetime Provider system could be detrimental to saver outcomes by distracting attention from the fundamental requirement of DC savings that higher contributions are more likely to result in better retirement outcomes. We would prefer that resources are used to increase education on how DC pensions work and the importance of contribution rates rather than possibly muddying the waters further with more decisions.
- Decumulation solutions – how will the Lifetime Provider model provide good value decumulation options for savers? Will Lifetime Providers be obligated to provide decumulation services for their savers or will this be left to the market to solve?
- Clarity about what the proposed exemption from the Lifetime Provider model for employers who offer a "better" offering than the Lifetime Provider as mentioned in paragraph 133 of the CfE. Who is this exemption for, what does it cover and how is "better" measured and against what? Additionally, would complex arrangements such as hybrid or underpin arrangements be exempt from the Lifetime Provider requirements?

2. What are the alternative viable mass market vehicles, including CDC, that can provide security for members while spreading risk, and address the transition into a pension income?

We agree that CDC has the potential to provide good outcomes for pension savers and are supporters of this and welcome the work being done on CDC regulation. We also support innovation in the DC decumulation space, with growing numbers of providers offering hybrid post-retirement journeys, similar to the 'Flex First, Fix Later' model which LCP has proposed. This involves an initial phase where retirement funds are held mainly in drawdown, invested for growth and accessed flexible, but moves to a later phase where there is a switch to an annuity, providing longevity pooling and reducing or removing investment risk.

With regard to the accumulation phase, there is a better alternative to the Lifetime Provider model, which could remove the need for all the cost and infrastructure around the multiple default consolidator model, and also only need a more light-touch infrastructure than the Lifetime Provider model. This is 'pot-follows-member', where pots go with an employee to their new job unless the employee opts out. You will be aware from our previous submissions that we remain supporters of this model and we wish to say again that advantages include:

- This does not undermine the fundamental advantages of the present structure, notably that employers continue to provide a single scheme for their entire workforce, with the advantages that this brings in terms of VFM, especially for those on more modest earnings;
- It is intuitively simple – when I change job, my pension goes with me
- It can build on the infrastructure of the pensions dashboard, which will already link the vast majority of pension arrangements to a single ecosystem;
- It places very limited additional burden on employers, as most of the work is done between the old and new pension arrangement;
- It promotes engagement because the employee will increasingly have a single and growing pot with the *current* employer;

There has been some suggestion that pot-follows-member makes it more difficult for DC schemes to invest in illiquid assets. But we do not believe this is the case. The DC sector is enjoying very large net inflows of contributions, and this will continue and grow in decades to come as mandatory AE contribution levels increase. It is therefore not necessary for DC schemes to be continually buying and selling assets to facilitate pension transfers when people move jobs. They already have plenty of liquidity to deal with this. In addition:

- Only a small percentage of a scheme's assets will actually be transferred in any given year in any case, and this is quite consistent with a meaningful allocation to illiquids;
- Schemes could 'net off' transfers between each other – for example if £1bn of assets needs to go from "Master Trust A" to "Master Trust B" because of job changes, but £1.1bn of assets needs to go from "Master Trust B" to "Master Trust A", then there could simply be a net transfer of £100m; this would greatly reduce the necessity for buying and selling of assets; (this is presumably similar to the way that the banking system reconciles transactions at the end of each banking day);

3. What are the other considerations and building blocks that need to be in place before moving to a single lifetime provider, including any transitional arrangements?

- We have primarily set out our main considerations in our answer to Q1. We would add that the government needs to decide what is their top priority for DC pension savings. These new Lifetime Provider proposals are coming on top of existing plans for DC pensions such as default consolidators, decumulation, VFM and Dashboards, the impact of which is still unproven.
- It would be sensible to have the results of the FCA's ongoing review of the advice/ guidance boundary in place and implemented before any introduction of Lifetime Providers. Two of the proposals for targeted support and simplified advice could be helpful for savers making decisions about Lifetime Providers.
- If a Lifetime Provider system works as we think the government intends, this could lead to savers concentrating their pensions into a single vehicle – but without much guidance or oversight as to whether what they choose is correct. This creates an "eggs in one basket" risk such as a saver being exposed to a provider that fails or investing all their contributions into a cash fund which loses value in real terms over time. Procedures must be put in place to safeguard against this.

- data standards for automatic and efficient processing of payments will be needed –
- anti-scam measures - once an employee can require an employer to redirect their pension contributions somewhere else, making sure those transfers are to safe destinations becomes vital; although government will no doubt regulate approved 'destinations' for such transfers, experience of DB to DC transfers highlights some of the challenges with this; and once the 'member choice genie' is out of the bottle, how long before people want their pension money to go into their alternative investment platforms, after which there would be very little quality control. Another red flag/ amber flag process would need to be set up which will, again, add further complexity and cost for little clear benefit for most savers.

4. What are the advantages and disadvantages of moving to a member-led lifetime provider model prior to considering introducing a default lifetime provider model?

- As drafted, this question narrowly focuses on the advantages/ disadvantages of two ways of introducing Lifetime Providers, rather than the advantages/ disadvantages of Lifetime Provider overall, and we are uncomfortable that it presumes that Lifetime Provider will happen in some form.
- Addressing the question as it is written, the disadvantage of a *member-led* Lifetime Provider model is that it will still require all the infrastructure, and hence cost, of a compulsory model but take-up is likely to be limited to relatively few savers. However, one possible advantage is that it might result in a relatively low-volume "running in" period where snagging problems in the infrastructure can be addressed before a potentially higher-volume compulsory model starts operating.
- In terms of using 'member choice' as an interim step to 'Lifetime Provider', there is a risk that the latter could be seen as more restrictive than the former. With a Lifetime Provider (and assuming this is delivered by 'stapling' to the member's first pot), the member presumably has a choice between their contributions going by default to their first Provider or to their current employer's scheme. But with 'member choice', presumably the member can pick any scheme of which they have been a member? If, alternatively, 'Lifetime Provider' allows members to specify any previous pension scheme then the only real difference between the two is the 'default' outcome – with 'member choice', the default is presumably the current employer whereas with 'Lifetime Provider' it is presumably the first scheme. More details would need to be required to discuss the merits of this.

5. What is the right timing and sequencing of these potential changes? Which part would best be implemented first and why, or should any be implemented concurrently?

- We believe that existing pension initiatives as already mentioned above should be followed to their conclusion first before further radical changes are introduced. In particular, there is little doubt that the single biggest problem in DC pensions in terms of securing good member outcomes is the low level of contributions. Implementing the recent primary legislation which delivers the recommendations of the 2017 review must be a priority, followed by a further roadmap to delivering a higher total level of contributions (eg gradually increasing contributions from 8% to 12%, split evenly between employers and employees as recommended by the PLSA, we strongly support this and all the other recommendation in the five steps to better pensions research the PLSA undertook: Five steps to better pensions: time for a new consensus (plsa.co.uk)). We believe these areas would make a much more significant contribution to good outcomes than these new Lifetime Provider proposals.
- We urge the government to remember that employers, the pensions industry *and the Civil Service and the Regulator* only have limited capacity to deliver new proposals. The member choice/ Lifetime Provider model requires further major upheaval, consider additional cost in creating new infrastructure and new burdens on employers. It should not proceed unless there is a very clear rationale for reform and a proper cost-benefit analysis. A decision on implementation should also wait until other initiatives such as the Pensions Dashboard have had chance to bed in, with any resultant changes in member behaviour taken into account in designing further reforms.

Conclusion

As will be clear, we do not consider that there is a compelling evidence-based case that Lifetime Providers will improve outcomes for the majority of pension savers and therefore we do not think there is a need to use up

government and industry resources setting up such an infrastructure – which could well become an expensive white elephant – at the expense of other policy initiatives which are more demonstrably likely to improve member outcomes. However, we are open to being convinced by further evidence and would be glad to discuss these matters further with you.

Yours sincerely

{By email only 15.00 24 January 2024}

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