PENSIONS AND LIFETIME SAVINGS ASSOCIATION

FUTURE OF THE DEFINED CONTRIBUTION PENSION MARKET: THE CASE FOR GREATER CONSOLIDATION

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EXECUTIVE SUMMARY

We think that scale is an imperfect proxy for quality and we do not believe that larger and fewer schemes should be an aim in and of itself. Rather, industry and government should be working together to improve member outcomes and to ensure that better schemes, not just larger schemes, should remain in the future market. Scale is not the sole determinant of scheme quality. We support the principle of scheme consolidation where this is in the interest of members, for example through superfunds, use of master trusts (DB/DC) or pooled services. However, it is important to recognise that schemes of all sizes can deliver excellent outcomes for members, and consolidation should above all serve this purpose.

We urge the government to consider prioritising regulatory interventions that will have the most positive impact on retirement outcomes. Member outcomes are more likely to be positively impacted by efforts to improve pensions adequacy more directly, such as protecting employer contributions, increasing member contributions and enhancing support throughout the decision making journey. Maintaining the employer link and support for pensions across schemes of all sizes is highly likely to provide for better member outcomes when all relevant factors are considered. For example, the Government should assess to what degree consolidation has driven better outcomes when compared with higher contribution rates.

The average scale of DC schemes is already increasing as the market matures, due to both automatic enrolment and market forces that allow schemes and employers to choose consolidation where in the best interest of members, particularly as employers opt to use authorised master trusts. This trend to consolidation has already been significant in the past ten years; since the beginning of 2010 the number of non-micro schemes, including hybrid schemes, has declined by 66%[1]. The thresholds proposed by Government in this *Call for Evidence* do not seem to take account of factors such as the current concentration in the market or the mixture of commercial and non-commercial schemes and providers and likely risk unintended consequences. Natural evolution is much more likely to improve members' outcomes than a revolution to force consolidation at an unnatural pace.

We recognise TPR findings that indicators of poor governance can be more concentrated amongst smaller schemes, though we would emphasise and agree with Government and regulators that it is poor quality scheme governance and investment approaches that matter, not size. When pension schemes and providers do not deliver value for money they should consider whether they can improve their performance. However, we note insufficient evidence provided so far by the Government to support the suggestion that the benefits of consolidation outweigh the operational costs. In summary, we welcome the recent emphasis

[1] https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2020-2021

placed on schemes to consider consolidation, but only where there is evidence that this improves member outcomes.

Forced consolidation, particularly below such a high threshold, will reduce choice and competition and may exacerbate capacity issues that are already difficult to address within the market. Consolidation is complicated and may result in direct and indirect costs for members; it is highly likely that simplifying trustees' decisions on whether to consolidate or not to purely those relating to scale misses other more significant costs and benefits to members. Moreover, the benefits of pot and scheme consolidation differ and parallels may be unhelpful to draw, especially where scheme consolidation does not necessarily lead to pot consolidation, in some cases because legislation impedes this.

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CALL FOR EVIDENCE QUESTIONS

Question 1: Do you agree that the government is right to aim for fewer, larger schemes going forward? Are there any risks?

There are benefits to consolidation and scale and we have generally welcomed the current trend towards consolidation, for example, where economies of scale can be harnessed for members' benefit and where it gives them access to a broader range of investments. However, we have not seen sufficient evidence to show that the benefits of greater consolidation of schemes up to £5bn assets under management could be justified on the grounds of improving member outcomes. When pension schemes and providers do not deliver value for money they should consider whether they can improve their performance.

Scale in of itself does not always equate to a quality scheme, and similarly small schemes do not always mean poor value for members. There are smaller schemes that are well run and provide good value for money for members, in some cases by assembling access to scale services in asset management and administration. These schemes would not benefit from consolidation as they already have the equivalent of scale via access to scale. Conversely, there are larger schemes which suffer from instances of poorer governance or homogenised, largely mainstream, investments. Good quality small schemes should therefore not be sacrificed purely for the sake of greater average scale across the market as this is only a poor proxy for improved quality. Larger and fewer schemes should not be an aim in and of itself, but rather industry and government should be working together to improve member outcomes.

We believe evidence is needed to understand the impact of these proposals on members outcomes:

- Analysis of the composition and concentration of the market, including but not limited to impacts on dynamic competition in the interest of members, choice for employers, innovation in accumulation and decumulation and value overall.
- Projection of the average employer contribution rate before and after any intervention, and a measure of the impact on members' outcomes.
- Review of member and member representatives' perspectives on existing pension provision being moved away from their employer's scheme, including but not limited to understanding the degree to which this creates confusion, undermines confidence in pensions or alters perspectives on the security of their saving or amount of control they have.
- Operational and administrative costs and burden associated with consolidation and a net benefit assessment on members' outcomes for larger schemes. The Government should also undertake to understand how these costs would be met and whether they put employer contributions at risk, and whether the burden would act as a drag on resource for other Government priorities such as Dashboards.

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- The economies of scale and efficiencies identified after consolidation under £100m and how these translate into materially better outcomes for members (or could do so) over the long term. A thorough analysis of likely diseconomies of scale.
- Analysis of the capacity and systemic/market stability risks that the market would face were the pace of consolidation to significantly increase. This should be including but not limited to scenarios such as: certain schemes achieve a significant proportion of the overall DC AE pension market, administration services are overcrowded, or where the demand for certain funds is overwhelmed creating market instability in the short term or performance drag in the longer term.
- Thorough review and assessment of the interaction with and dynamic effect of other proposals such as, but not limited to, the recent changes to the Normal Minimum Pension Age, permitted charges, engagement efforts such as the Simpler Annual Benefit Statement, Dashboards, pension transfers work (including scams red flags), FCA/TPR work on value for money in pensions and so on.

It is unclear whether the Government believes there should only be a handful of schemes left in the market. Based on access to current data we believe that, in extremis, were all schemes caught by this intervention to choose to consolidate rather than improve, this would result in tens rather than hundreds of schemes remaining in the market[2]. We are unclear whether this is Government's 'target' for DC schemes retained, but if it were to be we think this would fall significantly short of a sufficient number of schemes. By way of comparison, even in much smaller and more highly concentrated DC pension markets around the world like Australia hundreds and not tens of schemes are retained, and these markets suffer from shortcomings even at this level of reduction of schemes. We think these proposals, were this to be the intent of Government and were it to be practically achievable, risks far too few schemes remaining, essentially eradicates any competition and risks in significantly worse outcomes for members.

We believe that £5bn assets under management is too high a threshold for consideration at this time; we would like to better understand the analysis the Government has undertaken to assess that the 1,000 (non-micro) schemes projected to be operating in five years' time is 'too many'. Particularly, we would like to understand why other timelines and thresholds were not considered, and whether in the future once the market has developed, and if the £100m threshold demonstrably improved better outcomes for members, a lower threshold of, for example, £500m may be a more practical staging threshold to assess and consider towards the end of the 2020s or beginning of 2030s.

Employers are the most trusted part of the pension delivery chain, and trust increases the likelihood that members will contribute in the first place, or continue or increase contributions. There is a risk that unnaturally forced consolidation will weaken the employer link with pensions which must be protected in the interest of increasing adequacy for members. Employers should be also able to maintain their own scheme where they wish to. Single employer trusts schemes are often managed

[2] This assertion is based on the assumption that the £5bn threshold is DC only. On this basis we estimate that there would be fewer than ten single trust, and less than twenty schemes in total that are not caught by this threshold.

and run as part of a wider, integrated package of employee benefits, have higher contribution levels that materially benefit members' outcomes, and are likely to be highly bespoke to appeal to the specific demands of their employees. Sponsoring employers are already likely to gain from access to scale where they can and it is beneficial for them to do so, or be considering where and how they could. An undue focus on consolidating schemes could result in some detriment, as the employer may not be able to tailor the offering to their employees within consolidators, or retain the same level of interest as they did before. Please also refer to our recent consultation response on *Permitted Charges Within Defined Contribution Schemes*[3] where we also discuss the importance of the employer link for adequacy, and responses to other questions below.

Consolidation of the DC market is already naturally occurring[4]. It is widely expected that assets under management will continue to grow, and as schemes undergo value for money assessments they will seek out greater economies of scale. So far consolidation has been in the clear best interest of members as trustees have made independent decisions to consolidate. We have yet to see any evidence to suggest that members outcomes would improve significantly from speeding this process up. In fact, we believe there is evidence to suggest that accelerating consolidation may risk member detriment or adversely impact the speed of progress for other deliverables. Enforcing further consolidation without addressing these constraints may make administrative mistakes and errors more likely.

There are several reasons why, even post scheme consolidation, pot consolidation may not be possible or desirable, for example, where exact fund mapping is not possible, or where – for tax treatment purposes – it is important to know what funds 'belong' to which periods of time. Consolidation is further complicated by the fact that some members' pots have guarantees attached to them. Retaining these guarantees may be more valuable to members than scale. Tailored and bespoke consolidation to retain and grandfather specific guarantees, protections and preferential terms can, in some cases, be done though it's very expensive, complicated and creates risks for both savers and schemes. Consolidation for schemes without these kinds of member benefits is a complicated process which should not be underestimated as, for example, changes to payroll, benefits and HR systems are needed. To do this correctly takes time. Micro and small schemes can be the trickiest to consolidate. We are aware of many cases where schemes have not consolidated a balance of remaining members to keep their protections, resulting in a residual trust that cannot be wound up. In order to resolve some of these complications schemes have, in some cases, had to convert a number of DC to DB pots to facilitate consolidation or transfers. These complexities are expensive, time consuming and cannot be rushed without risk of detriment to members or errors.

Additionally, smaller schemes currently already have access to scale through pooled investment funds and other providers. This allows them to access some of the advantages of larger schemes whilst retaining the ability to bespoke to their members' best interests and retain control. Single

[3] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2021/DWP-permitted-charges-within-Defined-Contribution-pension-schemes-PLSA-response.pdf

[4] For example see PLSA's 2020 survey, *Facing the Future* https://www.plsa.co.uk/Policy-and-Research/Document-library/Facing-the-future-2020

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employer schemes can also leverage from their other schemes, for example, where they can gain exposure to scale illiquid investments through employers' existing associated DB schemes. For example, lots of large DB schemes have internal teams that manage both the DB and DC investments, which mean that even small DC schemes may be able to harness the benefits of in house investment expertise.

The *Call for Evidence* highlights that greater consolidation in the DC market could alter the deferred small pots challenge. It is important to note that consolidation of schemes will not necessarily result in pot consolidation. In many cases administration for different employers remain separate even after transfer to a consolidator scheme. Moreover, where pots have guarantees or special characteristics they may not be able to be consolidated (without loosing these highly valuable benefits for the member) with other pots even in a 'consolidated' scheme. However, having an eventual smaller number of DC schemes may make it easier to implement an industry solution for small pots where this relies on bulk transfers of significant scale to reduce the per-transfer cost. Though the solution would need to be in place before any significant consolidation were to occur to realise this eventual scale benefit.

Several of the ideas in the *Call for Evidence* are based on the assumption that members will benefit from greater economies of scale were consolidation to increase. We would urge the Government to also consider the degree to which poor value products and solutions are found in the workplace market when compared with the retail market. We think this analysis is important as the workplace market is likely to represent significantly better value than the retail market despite the significant scale sometimes observed there by comparison. The comparison with the retail market illustrates that many of the existing interventions in the workplace market are working well to improve value. It may also inform Government's views on potentials for diseconomies of scale, or help focus on specific areas other than scale that might indicate a proxy for poor value such as legacy products or inadequate governance, were the effects of the lack of charge capping and high fees for consolidation isolated from other drivers.

We would ask Government to be clearer about the aims and objectives of greater consolidation. If the main objective is to encourage investment in a more diverse range of assets this could be addressed in other ways. Equally, greater consolidation will not necessarily lead to larger schemes investing in illiquid assets. In Australia there is some evidence to suggest that net return comparisons across too short timeframes has acted as a disincentive to invest in risk seeking assets such as illiquids[5].

Question 2: What impact will the new value for members assessment have on consolidation of schemes under £100 million? If you were a scheme that did not pass the value for members assessment, would you look to "wind up" or "look to improve" and how would you go about this? Beyond the value for money assessment, could

[5] For example, see Chapter 3 of the Super System Review https://treasury.gov.au/sites/default/files/2019-03/R2009-001_Final_Report_Part_2_Chapter_3.pdf

government, regulators and industry accelerate the pace of consolidation for schemes under £100 million?

We do not believe that the new value for members assessment will significantly increase the rate of consolidation than the baseline trend we have already seen. This is at least in part because the trend to consolidation has already been so significant in the past ten years; since the beginning of 2010 the number of non-micro schemes, including hybrid schemes, has declined by 66%[6]. We also believe that in the first instance schemes should look to improve and should only consolidate where they cannot justify that improvement is in members' best interests.

We believe the focus should be on how to get everyone a better pension and retirement income, rather than on accelerating consolidation. Ensuring everyone receives a safer and more adequate pension could, for example, include a suite of activity such as taking firmer and more frequent enforcement action against those schemes that are poorly governed. By focusing on proxies for quality governance, such as scale, the Government risks prioritising creating larger schemes rather than better schemes. Indeed, the consequence of a more heightened and targeted approach to poorly performing schemes may well be increased consolidation as some TPR policy and approach intends. Consolidation should be a consequence of poorly performing schemes seeking access to opportunities to scale, or poorly run schemes exiting the market.

As stated at Question 1, there is a capacity issue with accelerating consolidation. Forcing an unnatural pace for consolidation will increase the risk to members and member experience.

Before any consolidation we believe further clarification will be needed to ensure that schemes are able to assess value for money in the best interest of members. In the previous consultation on the proposals for those schemes below £100m we stated:

- The Government should undertake further work to ensure that, where possible and appropriate, the approach to value assessments is consistent with the approach FCA has in contract-based schemes, and the forthcoming work on the value for money work that FCA and TPR are undertaking together.
- Further guidance on the data and other evidence they should make use of to assess value for money, as well as the methodology to use for assessing specific factors and making a 'holistic', overall assessment. This should include additional explanation and clarification of some elements, and how to weight different metrics to ensure that excessive weight should not be given to costs and charges when compared with other metrics, for example, net returns. Having a sound evidential and methodological basis will be especially important in cases where trustees declare that it would be in scheme members' interest to move to a better value scheme.

[6] https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/dc-trust-scheme-return-data-2020-2021

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- Further clarity and appropriate guidance on how to ensure the views of sponsoring employers, and also of scheme members, are incorporated into any subsequent decision to wind up a scheme and consolidate.
- These proposals do not clearly set the expectation that costs associated with wind up and transfer are included within the assessment of overall net cost benefit to members.

We believe that without consideration of the above, the impacts of any consolidation under a given threshold could be unpredictable and have perverse impacts on member outcomes.

Question 3: How can government incentivise schemes with assets of between £100 million to £5 billion to consolidate?

Our evidence suggests that this bracket would capture the vast majority of the market – we would estimate that this intervention is intended to encourage consolidation to all excepting a maximum of approximately ten schemes currently above £5bn. This would result in less than five single trust schemes outside the requirements and many of the recently authorised master trusts being asked to consider to improve or consolidate. We believe this undermines the significant effort by Government, regulators and industry to make the master trust authorisation regime a success. We also need clarity on whether the £5bn figure includes hybrids assets or is only for solely DC schemes; as we have explained elsewhere in this response and other written responses to Government, small DC sections of larger employer run pension schemes are highly likely to benefit from this arrangement to the advantage of their members.

We would like to better understand how the threshold of £5bn assets under management was chosen. We have concerns over further encouraging consolidation faster than the natural speed at which it is already occurring in the market place. However, were the Government minded to do so we can see the benefits of – over time - increasing the original £100m threshold were it found to be in members' interests. A second phase of slightly larger but still small schemes may benefit from undertaking the same exercise as those below £100m in several years' time, but only where the first phase was clearly a success and improved members' outcomes. This would have the added benefit of smoothing risk of capacity constraints or errors entering the transfer process, and enabling schemes and their advisers to learn lessons from successful consolidations in the past, while still targeting many of those schemes that do not meet TPR's governance standards.

Incentivising schemes is difficult because, where this is not in the members' best interest, schemes quite rightly cannot be 'incentivised' to do something that is purely based on their own scale. Trustees and scheme sponsors are already moving to consolidate where they think it is in the best interest of members and where costs could be reduced and so efforts to further 'incentivise' this are likely to be largely ineffective. Schemes would also be misadvised to place a burden on their existing scheme members or risk the value their existing members receive, even where they are incentivised to absorb smaller schemes. As we mention below in response to Question 8 if money incentives are available from government to support pensions we believe this might be better spent on initiatives to improve adequacy rather than increasing consolidation.

Question 4: (a) Assuming a scheme wishes to consolidate, how significant are the barriers identified above? Are there others? How do barriers vary for medium-larger schemes? How can the government, regulators and industry remove these barriers?

It is important to note that not all schemes will benefit from considering consolidation, and for many these are beyond just practical barriers that the question refers to. For example, for many schemes their members are highly unlikely to benefit from consolidation where they benefit from protections, guarantees or preferential rights, and therefore even before reviewing the components of potential improvement as set out in the value for money assessment schemes could be right to discount consolidation. We therefore think it very important that, as this question sets out, barriers for those specific schemes that are or could consider consolidation in their members' best interest should be separated from more general intentions to increase consolidation across the market.

There are a number of barriers for schemes wishing to consolidate, which include the transition risks and costs that schemes face when doing so, and the time taken to complete the transaction which at minimum is months and can be years. Some of these place the member experience at risk, others introduce administrative complexities, and still others are likely to be detrimental to members' outcomes. For example, one of the main barriers we have heard from schemes is the transaction costs that their members face when dis- and re-investing which impact members measurably and directly. This is particularly detrimental to the member when transferring small pots. We also know that hurdles associated with data quality, care and attention needed to design and deliver appropriate defaults and those complexities to which we have previously referred for preferential terms, protected benefits and guarantees also act as barriers.

Some costs of consolidation can be significant and at the moment tend to be picked up by the receiving provider. However, this may not be viable were there to be significantly more consolidation, and we are alert to the potential for these being passed onto to members. Particularly it is likely that this could disproportionately impact those with lower value pots. Moreover, even discounting the impact on individual member pots some smaller schemes will be unable to afford the overall costs of transition which acts as the ultimate barrier to consolidation even where a scheme wishes to do so. For example, in 2020 TPR's own consultation response noted that 'winding up a scheme with guarantees and moving members to a non-guaranteed alternative would be unaffordable for most small and micro schemes'[7].

As noted in previous questions there are also capacity concerns. There might also be barriers in terms of the schemes available for employers to choose consolidators that suit all of their needs. For instance, not all master trusts offer RAS schemes which some employers may want to use based on the composition of their workforce. This might limit their availability to consolidate the scheme where those master trusts that do offer RAS reach transfer capacity in any given period. Another example of capacity issues are the lack of implementation managers to oversee these large scale consolidation exercises.

Capacity issues can also manifest as mistakes. If schemes are forced or incentivised to consolidate too quickly there will be a higher risk of errors. Also, as previously noted, some pots may be complicated to consolidate if they have guarantees or protections. Recent Government interventions, such as changes to protected pension ages and the normal minimum pension age, have increased

[7] https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/future-trusteeship-governance-consultation-response-february-2020.ashx

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complexity and act as a disincentive to consolidate. Extra care also needs to be taken when consolidating these pots to ensure few errors occur. These concerns and administrative challenges should not be underestimated.

(b) How can government incentivise consolidation for schemes between £100 million and £5 billion especially where there may be a proportion of members who have smaller pots and therefore may be less attractive to receiving schemes? Could government incentivise trustees of both the merging and receiving schemes to take a mixed economy of smaller and larger pots or could this be provided by the market at a suitable cost, and without imposing additional cost consequences on members?

The majority of scheme consolidation is currently happening into master trusts. However, it is important to note that the master trust market is non-homogenous, for example some master trusts are commercial, others not for profit or government supported, some focus on different employment sectors, others can offer value through highly innovative technology-based solutions, or through connections with EBCs or asset managers. Currently some master trusts incentivise other schemes to come to them by picking up costs or offering beneficial deals, or others seek particular characteristics of ceding schemes in order to maximise the opportunities to capture economies of scale for members' benefit. If pressured to consolidate this may no longer occur. Too much consolidation could put master trusts at risk where they are receiving schemes that they are not able or comfortable to take on or create unhealthy concentrations, which would distort market performance.

As noted in our response[8] to the government's *Permitted Charges Within Defined Contribution Schemes*[9], restricting charging structures could be a disincentive to schemes accepting smaller pots. Some master trusts are only able to accept smaller pots on the basis of having a combination charge rather than a single charge. If the combination charge were to be removed those master trusts may not be able to facilitate schemes for the wider range of employers that they can currently and receive these schemes with many smaller pots.

Smaller pots are not the only issue. Indeed single trust schemes often have larger pots than master trusts on average. Rather it's other factors that make schemes 'less attractive' to receiving schemes, for example, very complex guarantees, or different data collection and storing standards.

Question 5: How can we mitigate any risks associated with scheme consolidation?

Risks to members

There is a risk of costs being passed on to members. This could be mitigated through direct or indirect financial support from government for both consolidating and receiving schemes that suffer increased costs. These should be designed to avoid these costs being passed through to savers.

[8] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2021/DWP-permitted-charges-within-Defined-Contribution-pension-schemes-PLSA-response.pdf

[9] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2021/DWP-permitted-charges-within-Defined-Contribution-pension-schemes-PLSA-response.pdf

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However, if money incentives are available from government to support pensions we believe this would be better spent on initiatives to improve adequacy rather than increasing consolidation.

We believe that member experiences may be negatively impacted by increasing the pace of consolidation unnaturally, at worst through errors or mistakes that lost members money and require compensation. There are also other compromises that consolidator schemes may have to make in haste and deliver at speed, such as communications approaches that are less tailored and more generic. We would like Government to undertake research to better understand members' preferences (see also our answer to Question 1, bullet list).

Many of the risks we have identified are where consolidation is not in the best interest of members or is rushed. This could be mitigated by allowing more time for consolidation to occur naturally and only in the best interest of members. Further evidence should be gathered to understand this fully.

Risks to schemes

In answer to Question 2 we listed out some of the further work we believe that Government could do to mitigate the risks of consolidation on the basis of the current value for money assessment as envisaged (see the bullet point list). We believe these could make a difference to the overall effectiveness of this intervention, as well as help to mitigate some of the risks to schemes by improving the quality of the decisions taken by schemes that intend to cede to other schemes. However, we believe risks to schemes will still remain.

Risks to the market overall

There is a risk of reduced competitive pressure in the market by having a fewer number of schemes. More protections, like the charge cap, might be required to replace the lost competitive pressure and continuously improve outcomes for members. However, it would be difficult to mitigate the risk of lower innovation in the market were there to be fewer providers. This is a real risk, as seen in the Netherlands[10].

This intervention may not improve governance standards overall. Carefully designed governance interventions may be needed alongside to maintain the employer link within consolidator solutions. For example, increasing the number of member nominated trustees clearly could not sufficiently replicate the number of member nominated trustees across all single trust schemes currently, and therefore the degree to which smaller single trust employers can retain control and connection with larger commoditised providers, but efforts such as this could go some way to increasing appropriate member representation. We believe it would, however, be highly difficult to maintain the employer desire to consider market-leading pension provision as part of their employee offering where they are unable to retain complete discretion over the solution. Moreover, employers and employee representatives have often fiercely supported employee representation in pensions, and were consolidation to dilute this important voice in governing structures activities that they undertake to

[10] https://www.columbiathreadneedle.co.uk/en/inst/insights/revolution-on-the-horizon-will-the-dutch-pension-system-still-set-the-bar-for-sustainability-adequacy-and-integrity/

reinforce and enhance communications and attitudes on the benefits of workplace pension saving may suffer. It is therefore likely in our view that measures of adequacy would suffer.

Question 6: What other international good practice exists?

We have mentioned experiences from other jurisdictions where this made sense to do so (see Question 1 and Question 5). We would encourage the Government to inform any future assessment of proposals on consolidation to consider the following experiences from other jurisdictions, which will also help to inform where flaws could be avoided:

- Overall number of schemes in other jurisdictions in comparison to market size, for example jurisdiction 'x' has 'y' trusts in a market that represents 'z' percentage of the UK market.
- Scale in some other jurisdictions has been achieved over time in no small part due to higher overall contributions, not necessarily consolidation. The Government should assess to what degree consolidation has driven better outcomes when compared with higher contribution rates.
- As noted in the *Call for Evidence* charges in the UK are already lower than in other jurisdictions, and so cost savings will be minimal. The expected value to members should therefore be quantified with reference to cost saving achieved in other jurisdictions and translated into a reasonable equivalent for the UK, though we would not expect this to be material.
- Illiquid investments are more attractive to investors, including individual investors, in some other jurisdictions, and this can increase the overall proportion of illiquid assets held. The Government should consider what, if any, cultural shifts could be made to support this in the UK with reference to successful interventions in other jurisdictions. These could vary enormously in scope, and could range from education to increase individual investor (member) understanding and engagement in the UK right through to altering the nature of the commercial imperative in profit making pension providers.
- An assessment of the detrimental effect of innovation that has occurred in some other jurisdictions as a result of unnaturally accelerated consolidation or value for money comparison and declarations, and any protections that the UK requirements should reflect in policy design to reduce this risk.

Question 7: (a) How important is scheme consolidation in driving better member outcomes?

We define better member outcomes as enabling members to have a greater income in retirement. Two of our Policy Board objectives are that we *address the challenges of scale and pensions*, and *achieve well run schemes* (largely equivalent to the 'governance', 'charges' and 'investments' outcome measures the Government includes in this *Call for Evidence*). We have assessed that our Policy Board objective of *well run schemes* is a possible outcome of this intervention where schemes are consolidated exclusively into 'better' schemes, and no members end up in a detrimental circumstance.

However, we have a further two key objectives that the Government analysis of these proposals are largely silent on - *encouraging effective engagement* and *supporting adequate contributions*. It is this latter objective which we have assessed as highly unlikely to be positively impacted by the proposed intervention. Indeed, in our view it is likely to be negatively impacted as breaking the employer link is likely to reduce overall employer contributions.

We find this highly problematic as, according to PLSA analysis, if we look at all of today's workers, our modelling tells us that at an automatic enrolment contribution rate of 8% of band earnings (with the lower band removed as Government has promised from the mid-2020s) and assuming an annuity is purchased at retirement, far fewer future pensioners will achieve each of the Retirement Living Standards than they do currently. Looking at the working population, nearly a quarter (23%) will not achieve a minimum living standard in retirement.

Higher contributions are considerably more important than scheme consolidation in driving better member outcomes. Fees might have a small impact, performance might have a larger impact, but the biggest single impact is contributions which has nothing to do with scale. For example, PPI modelling undertaken on behalf of the PLSA showed that for a basic rate tax payer, their average total retirement would increase from £14,100 a year at 8% contributions to £16,400 at 12% contributions[11]. Smaller or single employer schemes often have higher employer contributions so members may achieve much greater value for money in these schemes than others.

Consolidation is only likely to be significant in driving member outcomes where as a by-product of poor behaviour and member outcomes schemes that perform poorly are the ones that consolidate; consolidating all schemes does not necessarily improve member outcomes. For this reason, we think it important that further consideration is also given to 'smarter' and less resource intensive monitoring and proportionate enforcement against poor quality schemes is a focus alongside efforts to consolidate schemes; this should be based on more than value for money assessments by schemes themselves but also review of the risk based approach used by the regulator. Intervening to encourage consolidation does not actually improve the governance of poorly run schemes and instead assumes the best case scenario that they are eliminated through the process of value assessment.

Lessons may be learned by addressing other proxies for value not just scale, as we mention elsewhere in our response (Question 1) with reference to retail products and solutions, legacy products and inadequate governance. Schemes that have already improved through own initiative or regulatory improvements should not be incentivised to consolidate where this is not in members' best interest. Such improvements would be many and various, such as efforts to improve decision making, collecting cost information by using the Cost Transparency Initiative templates and TKU improving governance initiatives.

(b) What more can government and industry do to move away from a narrow focus on low costs and charges to a broader assessment of value for money that encompasses investment strategies whether innovative or otherwise and overall net returns?

[11] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2021/Pension-tax-reforms-implications-for-savers-July-21.PDF

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Regulators must complete their work to define value for money in pensions. A discussion paper on this topic is expected from TPR and FCA, and schemes are already reporting value for money assessments in publications. Additionally, evidence is needed to show that value for money assessments will make a material difference to members outcomes, rather than just place a burden on schemes to disclose further information.

It is also important to appreciate that efforts to increase competition have dramatically reduced investment costs in the DC market. As providers now seek new ways to attract customers, new areas upon which competition operates will emerge organically, improving other areas of value for money. Efforts in charge capping have minimised the harm from disproportionate charges, but other efforts will be needed to maximise value for members.

Additional reporting of risk adjusted net returns could be helpful to members where the information is presented in a meaningful way, as well as to other schemes in order to compare net returns for the purposes of value for money assessment where presented over a sufficiently long time period. We support reporting of net returns as an important part of facilitating comparison between schemes (where the proposal requires) on factors wider than cost. A holistic consideration of charges in the context of overall performance, particularly where risk adjusted, are welcome but they do not equate to a value for money assessment. Moreover, reporting net returns over too short a time period may create perverse incentives to de-risk portfolios to reduce the likelihood that higher risk investments that are necessarily more volatile effect the overall short term performance negatively. We would discourage the Government from pursuing the idea of net returns floors without significant analysis of the dynamic effect this is likely to have on the drivers of competition in the market, as this could act as disincentive to invest in risk seeking assets such as illiquids. We have previously called for longer term past performance and net return assessments and still believe these would be more appropriate, and we would like to see this reflected in the proposals.

We do not believe that a different assessment for single employers would be an appropriate measure unless evidence to suggest that these considerations are materially different for single employer schemes.

Question 8: How can government, regulators and industry incentivise scheme consolidation?

Please also refer to our answer to Question 3.

A clear long term regulatory strategy would assist schemes through providing certainty on the intended Government focus and priorities. Were schemes better able to understand the expectations both for them as individual providers for their members and the overall guiding principles and timelines, they would be better able to concentrate on those factors that are most significant to delivering good outcomes on value, governance, investment and member engagement efforts like Annual Statements and Dashboards.

We struggle to see how incentives are appropriate or practical in this context. Theoretically, Government may be able to incentivise scheme consolidation by subsidising transition costs

(including transaction costs) so that members and employers are not out of pocket, or by removing complexity from certain benefit or regulatory obligations. This would need to be long term as a one-off financial incentive would not necessarily 'compensate' for the potentially small pot sizes or low rates of ongoing contribution and the impact on the receiving scheme's financial resilience. However, if money is available from government to support pensions we believe this would be better spent on initiatives to improve adequacy rather than incentives to increase consolidation as the former is empirically more likely to improve member outcomes in a meaningful way.

It is also worth noting that we agree that opportunities to consolidate and access to scale may be limited where receiving schemes do not find incoming schemes attractive. We note that the Government is interested in overcoming this barrier, but struggle to comprehend how this would be possible without subsidisation of administrative costs of running a pension with the intent to deliver 'zero cost' pension provision.

Question 9: Is there anything else, not covered in the other questions, that the government should consider?

<u>Investment strategies and illiquid investment</u>

There was no specific question on investment strategies within the consultation but the following ideas were mooted which we have explored in turn.

Apparent Government supposition: larger schemes have the capacity to invest in a more diversified portfolio

We believe this could be true only where small schemes are unable to access scale in other ways. We know of many small schemes with highly diversified portfolios via pooled funds, and suggesting that larger schemes have greater capacity for this oversimplifies the case in respect of member benefit. For example;

- Small schemes may be less homogenised and more bespoke investment solutions may be available. Particularly, well run single trust schemes are more paternalistic about their membership and often therefore embrace investment strategies that have a longer time horizon than other scheme types. Larger single trusts have often been highly innovative and embraced sophisticated diversification techniques when compared with for example other more commercially minded providers despite the fact that the latter are larger.

- There are benefits that are derived from being a small DC section in a larger DB scheme, including access to illiquid investments. Even as these benefits reduce as DB sections approach their endgame, trustees will consider opportunities to replicate the scale advantage their DC section used to receive through the DB scheme and may, at that point, consider consolidation opportunities. Again, schemes such as these would be unlikely to consider themselves 'poor value' and rightly receive significant member, member representative and employee representative support to remain.

- Trustees will take decisions on investment strategies on the best interest of members, regardless of their size. The government has not provided evidence that smaller schemes are more likely to choose to invest with disregard for their members best interest. Moreover, large schemes can also be guilty of highly commoditised, mainstream liquid asset classes or otherwise ‘uninspiring’ investment options, too.
- Competition on price has so far driven the low cost provision that the vast majority of pension savers are now beginning to benefit from. The competition on price may act as a disincentive for illiquid investment, and may continue to do so where efforts to deliver efficiencies are the key focus of employers. This dynamic effect is relied on elsewhere in the *Call for Evidence* as it is supposed to enable the member to derive increasing value from providers; as the market reaches maximum cost efficiency and continues to evolve other ‘value’ factors will rise to the top as key proxies for value, one of which may include more adventurous investments with the opportunity for increased returns.

Apparent Government supposition: Illiquid asset exposure is a proxy for better member outcomes

This is a complicated issue, and we believe that this is far from the sole reason for some schemes having suboptimal investment strategies or indeed poor member outcomes.

Smaller schemes are able to access scale opportunities through avenues other than consolidation, albeit some argue this is to a lesser extent in illiquid assets, despite the availability of pooled funds and continued innovation in the market. We consider it important to explore the barriers to scale opportunities within the market, and would encourage the Government to connect relevant recommendations and other ongoing initiatives.

As we have mentioned elsewhere, comparison on net returns may act as a disincentive to invest in illiquids where comparisons are made across schemes on shorter time periods. This can incentivise de-risking, and therefore less illiquid investment. Exposure therefore may be affected by Government interventions in unintended ways over time, and may or may not be an independent factor that can be isolated as the cause for improved member outcomes.

Interactions with other Government and Regulator proposals or inaction

- Dashboards readiness efforts may improve data quality of the smallest schemes, which is otherwise likely to be a significant barrier to consolidation into larger more commoditised solutions. However, this will have a limited impact for some of the schemes that are likely to be the most complicated to consolidate in any case, for example where records are kept in analogue or antiquated digital formats and where the phasing of dashboards means that the timelines over which data will be made available is much longer term. Moreover, schemes and employers will be reluctant to spend significant sums on technology development or data work where they believe they may be subject to pressure to consolidate.
- Recent changes to the normal minimum pension age, significantly increase the barriers to pot consolidation in all circumstances, within schemes and between schemes. Single trust

schemes are able to offer member benefits, such as preferential rights or protected benefits, that are likely to be highly positively impactful to members outcomes. In these cases it is highly unlikely that schemes' value for money assessment will result in consolidation.

- The robust assessments undertaken regarding the highly positive impact of increased contributions on pensions adequacy in the 2017 review should be a priority to make sure that contributions rise to 12% before the end of the decade. This change would have a positive impact on both scale of pots and schemes in the UK, from which many of the benefits envisaged by this consultation would arise without additional intervention.

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