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Rt Hon Stephen Timms MP
Work and Pensions Committee
House of Commons
SW1A 0AA

SMALL POT PROLIFERATION

Dear Mr Timms

We write to share our views and evidence on the issue of small pot proliferation. We are pleased to see this problem getting policymakers' attention and believe there is a strong case for changes in the way the market works.

Scottish Widows helps over four million customers save for retirement. With our diverse customer base, including longstanding savers as well as the newly enrolled, we recognise that an existing challenge is going to rapidly become a bigger problem.

Automatic enrolment and changing trends in employment will increase the number of small, deferred pension pots as individuals change employers and are enrolled anew, often with a different pension provider. The scale of the problem is highlighted in recent research from the Pensions Policy Institute (PPI), which projects that the number of deferred pots in master trusts alone[1] will rise from 8m now to 27m by 2035. This is not unexpected; government and industry both anticipated this consequence of AE and for this reason the concept of 'pot-follows-member' was considered some years ago.

There are several reasons why small pot proliferation should be addressed

- It can be more difficult for an individual to manage their total pension savings if it is fragmented in many places. This might hinder, for example, changing addresses, remembering passwords, and making changes to investments.
- It presents a barrier to engagement. We face an uphill task in getting people interested in planning for their financial future. Any additional friction is unwelcome.
- There is an increased risk of 'lost' pensions.
- It creates inefficiencies in the system. Costs are duplicated many times over. Reducing these should see customers benefit from lower charges. Very small pots tend to cost more to run than customers pay in charges. This may threaten the sustainability of some providers' business models.
- There is a risk of pot erosion, where some charging models used in AE have flat fees in addition to charging a % of a customer's fund. This can see pots reduced to zero, presenting

[1] [1] We refer to the PPI's numbers because this is the best and most recent research on this subject. But this is not a problem for master trusts alone. Contract-based pensions represent a significant proportion of the market and will continue to do so. Small pot proliferation is an issue for all types of defined contribution pensions.

problems not only for the individual but also for the AE brand, where trust is essential if we expect customers to save enough for retirement.

The aim therefore should be fewer pension pots. This might be achieved by more consolidation, or by reducing the creation of new pots – or a combination of both.

Consolidation options

A number of ideas are being discussed in the industry as to how consolidation would be best achieved. We believe a number of different solutions could work, perhaps in combination, but more work is required to fully define some concepts so they can be adequately critiqued and further analysis of costs and feasibility will be also needed. We make some key observations on the different options in the attached appendix.

We stress that both defaults and choice will need to be part of any solution(s). Relying on customer-initiated action will not make significant inroads on the problem. But, if consolidation happens by default, customers should be notified and have the option to opt-out of any transfer, leaving their money where it is. Consolidation is likely to be good thing for members overall, but they should be in control of their savings.

Should we be consolidating small pots or all pots?

We believe it will be necessary to define 'small pots.' This is about setting a value threshold for pension pots, under which it would be beneficial and acceptable for a default (not saver-initiated) solution to take place e.g. automatically transferring a pot unless the saver opts out.

We expect to need this threshold because there are challenges presented by default solutions. For example, a saver might be moved to a product with a higher charge, or poorer performance. This is generally mitigated by the charge cap and high standards of governance in workplace pensions but remains an important point. Paying an extra 0.25% on £500 is £1.25 a year. On £50,000 it's £125. There are also competition issues and potentially negative unintended consequences, as we outline in this letter.

There are a number of ways to set the threshold, for example:

- It could be at the point up to which flat charges can erode the value in a customer's pension. Pots under £500 are thought to be particularly vulnerable.
- We could also consider how many pots the average person will accumulate over a working life and set the bar high enough that the average person is only likely to have a small number of pots to manage in the later stages of their working lives.

We don't propose a 'magic number' in this letter and would not recommend attempting to set the threshold in isolation of the specific solutions considered.

Undesirable outcomes

As ever, we should be wary of unintended consequences and the following should be considered when weighing up proposed changes.

Charges

We should be mindful of how workplace pensions are charged and how this is often different from products in a retail market. While some providers also use flat fees, the main charge is a % of a customer's fund. Some providers have a single % charge for all their scheme members across all employers. Others offer different charges to different workforces. Both methods involve an element of cross subsidy: as the marginal cost of serving each customer is the same whether they have small or large amounts of savings, customers with larger pots effectively cross subsidise those with smaller pots.

In a retail market, savers with big pension pots can get the best deals for themselves and those with smaller savings pay higher charges as a % of their fund.

Customers are already free to move their money out of workplace pensions to see if they can get a cheaper price based on their own pot size. If we seek to accelerate the rate at which this happens it's difficult to see charges falling in workplace schemes.

It's also important to remember that some (usually larger) employers cover administration costs themselves and members who transfer out of such unbundled schemes will lose that benefit.

Where pension providers add value

It might be useful to look the value workplace pension providers offer and split it in two broad categories:

1) running workplace schemes: collecting contributions, helping employers comply with their AE duties and engaging their workforce
2) looking after and growing customers' savings

The first category is more costly and arguably more valuable in our collective efforts to help Britain save enough for retirement.

The second is cheaper, easier and more profitable. It's also possible to hold this role (as a consolidator) without playing a part in running schemes.

If, in attempting to solve the small pots problem, we accelerate the rate at which substantial savings come out of employers' workplace pension schemes, we might find fewer and fewer providers interested in running workplace schemes and instead trying to position themselves as a destination for savings others have helped customers accumulate.

Trust

There is a risk of disenfranchising customers. If a transfer is initiated by default, savers need to understand why this is happening and why it should be good for them. We want customers to build up a healthy amount savings in fewer places. That is better for them and for the industry. We do not want them to feel like the industry is not on their side or has decided they're not worth helping.

<u>Cost</u>

As well as implementation costs, we need to be mindful of the frictional costs generated by an ongoing churn of extra transfers. This will have to be weighed up against the efficiencies generated by removing duplication. Processing transfers in bulk exercises may be cheaper but wouldn’t suit every consolidation option.

We would be happy to provide further information and to answer questions from the Committee.

Yours faithfully,

Pete Glancy
Head of Policy
Scottish Widows

APPENDIX – Our early observations on the consolidation ideas being discussed by industry

CONCEPT	ADVANTAGES	CONCERNS
Pot follows member. Small, deferred pots are automatically transferred to a new scheme after a member is newly enrolled, unless the savers ask for their pot to stay put. We imagine this would rely on the pension dashboard infrastructure, which potentially would allow receiving providers to identify the previous pot and initiate a transfer.	Likely to have high impact in consolidating pots going forward. Unlikely that this will risk trust in AE. There is an obvious logic in transferring to a new scheme so customers would understand why it is happening. There are already digital transfer infrastructures that some pension providers use, and the dashboard may give a strong platform to build from	It may not address the high number of small, deferred pots that have already been created. A reliance on the dashboard would mean it will take a number of years to implement. Potentially high frictional costs.
Member exchange. Providers mutually agree transfers of deferred pots.	Currently, this may be possible for trust-based pensions without changes to the law. It may be possible using existing data sets (no waiting for the dashboard)	Communications need to be carefully managed to maintain customer trust. Large financial services customers 'trading' customers might be mistrusted, even if well intentioned. It may be difficult for trustees to sign off on the transfers, considering their fiduciary duties. Likely to lead to patchy coverage of small pots.
Default consolidator (backed by government). Small pots are transferred to a state-backed consolidator. This could be for the long-term, until the customer takes their benefits or transfers out. Or it could be for the short-term and the consolidator could have the aim of transferring the small pot when the saver is next enrolled in a pension scheme (this makes it similar to pot follows member).	Customers who regularly move jobs and build up lots of small pots could see their savings accumulate in one place. This is likely to have high impact in consolidating pots going forward. It could also sweep up existing pots. There are potentially lower frictional costs – providers could make bulk transfers, every quarter, for example.	Risks customer trust in pension providers and AE more generally. We can't afford for people to feel like the industry is rejecting certain customers or isn't on their side. Doesn't necessarily reduce the number of small pots customer have to manage – may just move one from one place to another (although multiple small pots would be consolidated to one) Costs – would this be paid for out of general taxation,

		increasing the burden on public spending? Or would it be funded by an industry levy – and would that undermine the aim of increasing efficiency?
Default consolidator (commercial). This concept has been loosely defined to date, making it difficult to critique. It could involve a competitive market for the role described above. Alternatively, it could see savers' small pots automatically consolidated into one of their AE pots, which becomes a 'lifetime pot' of sorts.	Likely to have a high impact in consolidating pots going forward. Could also sweep up existing pots. The lifetime pot concept might be conducive to better engagement.	A dedicated consolidator will not be commercially viable if it only takes on small pots. However, if it takes on bigger ones there are risks around competition and distorting the market. The 'lifetime pot' concept risks accelerating a split in the market between running schemes and acting as consolidators. The latter would likely be seen as more commercially attractive unless only the smallest pots are consolidated. Potentially high frictional costs.
Employees choose their own pension provider. Again, there are various ways this might work. One version could see employees given the right to ask their employer to direct their contributions to a different scheme. A more major shift could remove employers from the selection process entirely and see employees either select their own provider or be automatically allocated (a carousel-type approach) to a provider, keeping the same pot as they move jobs.	This could put customer choice at the heart of workplace savings. It could make it easier for customers to have everything in one place. It does not involve lots of consolidation through transfers between schemes.	Adding a choice to the current framework is unlikely to make a big difference to the number of small pots. Higher earners may be more likely to use the option, meaning schemes could face higher charges if they're left with only the low/middle earners. Changing the current framework to something like the carousel approach would be a significant overhaul of AE, going well beyond the scope of the small pots problem. This could diminish the role of the employer in selecting schemes, supporting governance and good outcomes.