Written evidence from NOW: Pensions (APS0053)

Please note – we are only addressing Q10, the one that is highly relevant to our business and where we have been contributing to thought leadership in 2020/21. That is the issue of small pension pots.

Q10 : Can the issues around small pension pots be solved through behavioural changes by savers?

Summary

The success of auto-enrolment is tarnished by the trail of very small pension pots that the ten million new savers brought into pensions leave in their wake as they change jobs. Research that NOW: Pensions sponsored at Pensions Policy Institute last year showed that, left un-addressed, the numbers of small pension pots will reach 27 million by 2035 (9)

These multiple pots require a duplication of administrative processes from each provider, and the same research showed that members paying for this un-necessary duplication will be incurring an additional £240m of charges every year by 2035 (9)

NOW: Pensions were part of last year's DWP Small Pots Working Group and we encourage the Work and Pensions Committee to support the most promising of the solutions looked at by that group, the concept of a "Default Consolidator".

Below we explain how a Default Consolidator will work, show how it retains the important structure of an employer centred workplace pension and then builds a consolidated pension pot for the member out of each of the pension pots accrued from former employers. We show how emerging data of the choices people are making at retirement underlines the crucial importance of building a large pension pot over time, as small pots are simply cashed up and spent at retirement.

We also explain how Default Consolidator both complements and depends on the Pensions Dashboard, another Government project that retains our full support.

Introduction

We are delighted that Work and Pensions Committee has chosen to ask about the behavioural side of small pots.

In short, we do not believe the small pots problem can be solved simply through behavioural science. Our response will set out why we are of this opinion and will also present our solution – the creation of a Default Consolidator solution (also known by some as 'Master Pot'), which we believe can help solve this issue once and for all.

The importance of behavioural science

The UK's pension auto-enrolment programme, which has successfully brought over 10 million new savers into funded retirement provision, is built upon behavioural science. It was because of extensive academic studies in the US that we knew that our auto-enrolment legislation – started by a Labour Government and finished under a LibDem/Conservative Coalition – would be a huge success.

The rationale for the policy is based around overcoming the aspect of human nature that tends to defer long term decision-making in the present, because it can be put off until the future.

And it was overcoming this reticence to act that has made auto-enrolment a success compared to its predecessor, Stakeholder Pensions, which *merely* made simple good value pensions *available* in the workplace. Whilst Stakeholder Pensions garnered over a million savers within their first sixteen months, there were also tens of thousands of workplaces where the pension was available but had no takers. In those workplaces the pension plans were empty shells.

Auto-enrolment harnesses the behavioural principle of inertia. It is having exactly the results that the many US academic studies told us to expect, and which don't stop at simply getting people to join the scheme:

- 91% of eligible employees do join the auto-enrolment pension and contribute their money, alongside their employer's contribution and a Government contribution by way of tax relief (1)
- 90% of employers choose to set up the scheme on the basis of the bare statutory minimum contributions only (2)
- 99% of employees pay only the basic level of contributions, spurning the opportunity to make AVCs. (3)
- 99% of employees make no choice of investment fund. (4)
- 98% of deferred pensions are left where they are, with only 2% of members initiating a transfer to a consolidation vehicle (5)

In summary, it is the very bedrock of auto-enrolment that in turn leads to the proliferation of small pots that we now need to resolve. Each time an employee changes job a new pension pot is created, often leaving behind a small pot which evidence shows is likely to be cashed in rather than contribute to retirement savings

Last year we sponsored research by Pensions Policy Institute that showed that left unchecked, the numbers of small deferred pension pots will reach 27million by 2035 with the resultant duplication of administration charges costing members £240m every year. (9)

The imperative is to find a solution that can both work with that grist of auto-enrolment and at the same time begin to stimulate member engagement and fully support those that decided to take control of their retirement planning. That solution is the Default Consolidator, which a number of members of last year's DWP Small Pots Working Group felt in their final report was "is likely to be an optimal approach" (7).

How the Default Consolidator would work

Default Consolidator builds on the principles of auto-enrolment , harnessing the power of inertia, recognising based on our, and other Master Trusts' experience, that left to their devices savers are unlikely to move their pensions savings around.

The Default Consolidator solution is that everyone should have two pension plans:

1. A workplace pension with their current employer, into which the employee is automatically enrolled and into which both employer and employee contribute.
2. A consolidation vehicle, their "Default Consolidator", into which their automatic enrolment workplace pension will be transferred when they leave that employer, unless the employee makes some other choice, such as transferring their pot to their new employer's scheme

The way that everyone gets a Default Consolidator is as follows:

Step 1. At the launch of the scheme, employers who are currently contributing to someone's workplace pension will choose a Default Consolidator for them. The responsibility is similar to the employer's current responsibility to choose an auto-enrolment pension scheme. In most cases, the providers of auto-enrolment schemes will also offer a Default Consolidator, and our internal analysis suggests there will be a vibrant market of Default Consolidator providers for employers to choose from should their auto-enrolment scheme not want to offer the consolidation service.

Step 2. Every time an employer commences pension contributions for a new employee, they will

a. Check with a central record (such as the Pension Dashboard) whether that individual already has a Default Consolidator
b. If not, they will choose a Default Consolidator for them.

Step 3. At any time, the individual can change their Default Consolidator from the one chosen for them to another one of their own choice.

Over the duration of someone's working life, their Default Consolidator will then receive periodic transfers from the workplace pension schemes of companies as that person leaves employment.

Rather like auto-enrolment, the transfer process will be an automatic inertia-driven process with a member opt-out facility. Just as happens today, when a member leaves employment they will be sent a pack setting out what their options are. Except that under the Default Consolidator model, this pack will also explain that one of the options is for the funds accumulated in the workplace pension to be transferred to their Default Consolidator, and that this will happen automatically within a set timescale if they do not select any of the other options.

Default Consolidator is a 'best of both worlds' solution

We believe that contributory pensions should be organised around the workplace. The employer is well placed to choose, monitor and manage the pension provider in the interest of their staff. Employer based pension schemes deliver economies of scale and reductions in cost, leading to greater value for money and more of the pension contributions being available for consumption in retirement.

61% of employers believe that their employees appreciate the pensions and workplace benefit package that their employer provides [(6)]. The workplace pension scheme can be a differentiating factor in the levels of welfare support that an employer offers compared to rival employers.

Default Consolidator preserves all that is good about employer-centric pension provision. It also buttresses the foundations of the auto-enrolment movement that has successfully delivered workplace pensions to ten million new savers that many amongst the traditional pension providers had thought were too difficult to reach.

But once the member moves on to another job and that employment link is broken, the workplace pension ceases to be the best home for the accumulated funds. A specialist consolidator is now a much better solution, allowing one large pot to be accumulated throughout a lifetime of job changes. Compared to the current landscape of several pots littered with past employers, one consolidated pot will have one consistent investment strategy, will provide one source of information such as the annual statement and incur only one set of administration costs. It will be dedicated to the task of collecting up pots from past employers and putting them together as one coherent source of retirement income for the years post retirement age.

Over time, as the relationship deepens, the Default Consolidator will seek to encourage and foster engagement of the saver with their retirement funds. So that by the time the member reaches retirement age, they are well equipped to make the important but difficult choices that await them.

One of the things that members may do as they become more “switched on” is to question whether the Default Consolidator that was originally chosen for them is still the right one for them. We note that a number of tools are already emerging from the fintech sector that can assist members here.

And where the member wants to change their Default Consolidator to a new one of their own choosing, this will simply be part of the fabric of the system. They elect a new Default Consolidator, the funds in the existing Default Consolidator are transferred over and all future consolidations will be automatically directed to their new Default Consolidator.

With the Default Consolidator model, the member that wants to be in control can be. Moreover, the member that wants to continue to allow inertia to take its course can do so, safe in the knowledge that someone else is looking out for them. We believe that most members will take the inertia route, but importantly they have the choice to do otherwise.

Criteria to become a Default Consolidator

We do not believe that any pension scheme has an automatic right to style itself as a Default Consolidator. The task of managing a growing pot throughout the lifetime of a member is a heavy responsibility, and the inertia that underlies the system requires that those running a Default Consolidator should clearly be looking out for the member’s interests throughout the whole process.

Within the occupational schemes environment, TPR have developed a higher level of regulatory approval in the form of an authorisation framework. There is already an authorisation process in place for master trusts, and only the best one third of the master trusts that were in existence before the Pension Schemes Act 2017 made it through the rigorous assessment process. In the wings are “SuperFunds” that will be similarly-authorised by TPR as first-rate vehicles into which employers may safely transfer closed final salary schemes.

We are of the opinion that that a similar authorisation process should be required for any pension scheme that seeks to operate as a Default Consolidator provider. This will ensure high levels of competence, probity and security for savers, who will have a lifetime’s savings inside a Default Consolidator. And we believe that this protection is important both for cases where the member was allocated to a Default Consolidator by their employer and where the member has self-selected their own Default Consolidator. Whether that choice was made by employer or by saver, there will be cases where the decision maker lacks financial expertise and is swayed by advertising and sales tactics. But with a TPR authorisation regime, savers will be able to have confidence that the Default Consolidator chosen by or for them is safe and appropriate.

Default Consolidator preserves every pension contribution, however small.

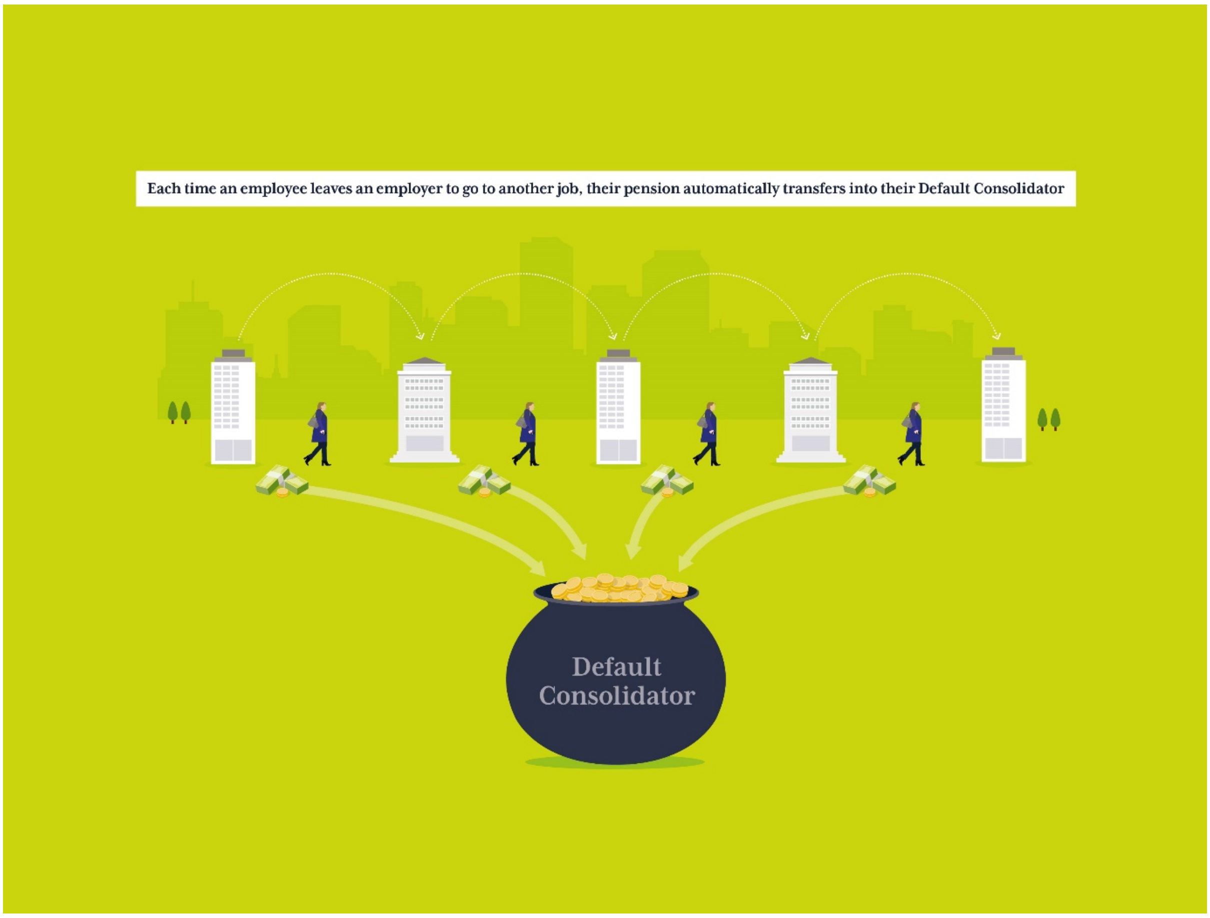
NOW: Pensions operates in employment segments with very high labour turnover. It is not unusual for our employers to lose over 40% of their staff in their first year of service and again in the second year. This of course does lead to some very small pension pots, and we have hundreds of thousands of members who left service quickly and left behind fewer than one hundred pounds in their account with us.

Our mission is to help people save for a financially secure future. So we want those few months of savings to be part of their future, not returned to them for spending today. They can't be a big part in themselves, but out of acorns oak trees grow and they should nevertheless be seen as an important part of building up benefits over time and making every period of employment count toward pensions saving. By demonstrating to people that all pension savings are valued, even if they are only a "small pot", we encourage the universal payment of workplace contributions.

Default Consolidator will welcome consolidating transfers of all sizes. Irrespective of how long the member worked for each employer, the Default Consolidator will, unless the employee chooses otherwise, gather up the savings made at that employer and add them to the Pot. Large or small, they all become part of the final solution for that saver. Large or small, they will always be welcomed with open arms and the saver will know that even the briefest period of employment has put its shoulder towards the eventual goal of a financially secure retirement.

Default Consolidator Schematic

The Default Consolidator solution resolves the small pot problem and enables deferred pensions to be smoothly aggregated into a saver's retirement savings. For the pension industry it simplifies what is today an administrative burden that delivers a beneficial consolidation process for providers, and for the government it continues the good work to help the under pensioned make the most of their lifetime savings. In simple terms Default Consolidator ticks a lot of boxes and moves the AE on further delivering against the Government's strategy "to ensure that the UK has a pension system that enables individuals to save towards achieving the lifestyle they aspire to in retirement, while minimising the challenges for employers and the industry". [1]

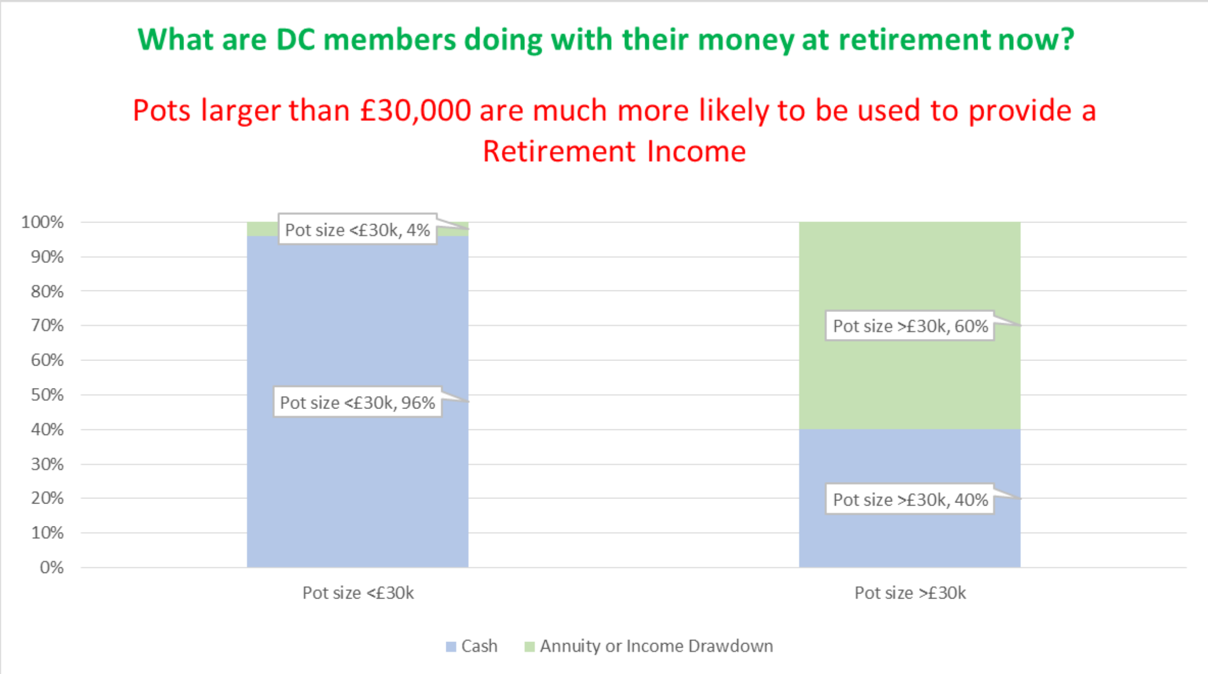


The Behavioural Effect of having one large pension pot

Removing the plethora of small pension pots from the current landscape is not just about tidying up and reducing the drag of duplicated administration costs on member benefits.

It also has a valuable behavioural effect on what members will do on their retirement. Since the Pension Freedoms, 96% of pension pots that are smaller than £30,000 are simply turned into cash at retirement. This money is unlikely to last long or provide a sustained income throughout retirement. In contrast, 60% of pension pots that are larger than £30,000 are used to purchase an income for retirement, either an annuity or income drawdown plan. (10)

Default Consolidator will gather all the small workplace pensions together into one large pot, meaning that those pension contributions and the tax relief provided by HM Treasury are much more likely to provide an income throughout retired life.



Data drawn from the retirement choices made over a whole year from 14,000 DC schemes with 4 million members [10]

Money and Pension Service also report a correlation between pension pot size and taking up the Government's free guidance service, Pension Wise. Three quarters of Pension Wise appointment bookers have pots greater than £30,000, with only one quarter of Pension Wise appointment bookers having pots less than £30,000 [11]

Alternative Solutions :

Our response to this call for evidence has concentrated on Default Consolidator as a solution to the issue of the rapidly growing proliferation of small pension pots in workplace pensions. We find Default Consolidator to be an eminently satisfactory solution to the problem, resolving the cost/sustainability issues for pension providers at the same time as creating a new framework that will engender much higher levels of member engagement with a growing pension pot over time.

There are other solutions that were looked at by the DWP Small Pots Working Group (7) and we list their drawbacks here :

a. Pot Follows Member – a system in which the pension pot is transferred at each change of jobs to the new employer's pension scheme. This would result in very large transfers towards the end of the member's career with inherent investment risks.

b. Lifetime Provider – a system in which the member chooses a pension provider for life, and wherever they work, their current employer sends monthly pension contributions to this scheme. But such an idea fails to recognise that a workplace pension is much more than just a contribution. And the resultant cherry picking, as some lifetime providers use financial underwriting to gather the most remunerative customers, would undermine the financial sustainability of automatic enrolment to the detriment of the vast majority of savers that automatic enrolment is designed to reach.
c. Member Exchange – a voluntary "swap arrangement" between large master trusts that will move the contents of an inactive pot at one master trust to an active pot at another master trust. Whilst this has the advantage of being allowed within existing legislation, subject to trustee discretion, its coverage would be limited
d. Refunding small pots – for workers that change jobs frequently such refunds could significantly erode their lifetime pension saving, essentially removing much of the benefits of the automatic enrolment regime. The average worker in the UK has 11 jobs in their career, while one in four have 16 or more jobs (8)

Pensions Dashboards

NOW: Pensions remains fully supportive of the Government initiated project to build Pensions Dashboards, providing all citizens with a comprehensive single view of their pension entitlement.

Like the DWP Small Pots Working Group last year(7) we do not believe that Pensions Dashboards remove the need for a small pots intervention. This is because many savers remain dis-engaged with their pensions and being able to see them in one place will not prompt the transfer activity necessary to resolve the wasted resource spent on the duplicate administration of many small pension pots.

But neither does Default Consolidator do away with the need for Pensions Dashboards. Whilst our model suggests that many will in future only have three pensions at any point in time – their State Pension, their current employer's pension membership and their Default Consolidator pot – we deliberately leave freedom for members to choose not to transfer their former employer's pension to their Default Consolidator. They may have very good reasons to want to leave it with their former employer, or they may wish to move it to a retail vehicle. Add to this forty years of old pension entitlements, many of which may have features unsuitable for transfer, and the ongoing need for Pensions Dashboards is apparent.

In fact, we posit that having a Default Consolidator pot that grows steadily through transfer receipts on each change of job will increase the level of engagement with pensions and that this increased engagement will drive increased appetite for and use of Pensions Dashboards.

The Default Consolidator model itself requires a central database that records the choice of Default Consolidator for every workplace pension scheme member. This function could very well be fulfilled by the MaPS Pensions Dashboard, although there are other potential homes too.

Implementation

Crucial to the implementation of Default Consolidator is a pensions industry process for the bulk transfer of many members at very low cost. Avoiding the proliferation of 27 million small pots will require millions of pots to be transferred into the Default Consolidators every year.

NOW: Pensions is pleased to be part of an initiative to create such an industry wide process along with the other largest master trusts, and we are feeding back the progress of that work into the current ABI and PLSA led Small Pot Co-ordination Group.

About NOW: Pensions

NOW: Pensions is an award-winning UK workplace pension provider. We look after the pension savings of tens of thousands of employers and millions of members from a wide range of industry sectors.

We have a clear mission - to help everyone save for a more financially secure future. This means achieving the best financial outcomes for our own members, while fighting for a fair pension system to enable all pension savers to enjoy the retirement they deserve. We do this by highlighting pension inequalities and campaigning for change.

We are the UK's third largest auto enrolment pension provider by number of members.

NOW: Pensions is part of the Cardano Group, a market leader in providing risk and investment management services designed to make pensions outcomes more stable and robust.

Sources :

1. DWP Automatic Enrolment Evaluation Report 2019
2. NOW: Pensions in house analysis of 30,000 employers participating in our master trust
3. NOW: Pensions in house analysis of two million employees in our master trust
4. NEST Insight, February 2021
5. Origo/TRIG data. Origo Transfer Index 2021 recording 800,000 transfers and TRIG June 2018 Progress Update showing the available universe as 60,000,000 pension pots
6. Willis Towers Watson 2017 Benefits Attitudes Survey
7. DWP Small Pots Working Group Report December 2020
8. Making Automatic Enrolment Work Review, Johnson, Yeandle and Boulding, 2010

9. Policy Options for Tackling the Growing Number of Deferred Members with Small Pots, PPI, 2020
10. Legal & General Investment Management, September 2019 to September 2020 data
11. MaPS Pension Wise Service Evaluation, September 2020

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