AN FTI CONSULTING REPORT

Consolidation Conundrum: Unpacking the Future of Defined Contribution Pensions

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The Labour government is keen to drive greater consolidation across all the different aspects of the pensions industry. This includes closed corporate defined benefit schemes, the Local Government Pension Scheme and auto-enrolled workplace schemes.

Throughout this whitepaper we take a closer look at how auto-enrolled pension schemes can be consolidated and made more efficient for the benefit of end members. When discussing consolidating defined contribution schemes, the focus is often on master trusts but we wanted to broaden the discussion and shine a light on other parts of the market, unpicking the individual challenges and opportunities of each.

The defined contribution market is highly fragmented with different types of schemes operating, many of which have existed before auto-enrolment came into force between 2012 and 2014.

This report looks in depth at the different providers operating in the defined contribution landscape and examines the issues in each and looks at where the best consolidation opportunities lie.

It also examines how consolidation can help greater investment in the UK, as well as how to address the creation of further small pots, how these can be consolidated and further ways to future proof the industry.

Thank you to all our panelists who contributed to this debate.

Andy Cheseldine
Professional trustee at Capital Cranfield

Tim Middleton
Director of Policy and External Affairs at PMI

Elizabeth Fernando
CIO of Nest

Maggie Kearney
Director of Defined Contribution at Redington

Tom Barton
Partner at Pinsent Masons

Political Snapshot

Nirmalee Wanduragala, Managing Director, Public Affairs, FTI Strategic Communications

Pensions have been in the policy spotlight for some time now, and for clear economic reasons. The impact of low or negative growth and rising inflation has coincided with the pressing need for greater investment, both public and private, in UK infrastructure[1]. Unsurprisingly, these reasons have led both major political parties to look at pension funds as a solution to the economic challenges of the UK.

The previous Conservative government set a direction of travel with the Mansion House reforms of 2023 that the new Labour government is continuing to follow. Both parties have been clear that value for money and greater consolidation is part of the solution to both better consumer outcomes (and reducing impact on state finances) and increasing investment in the UK.

Labour's surprise introduction of the Pension Schemes Bill in July, pushes this work forward, seeking to create a private pensions market that encourages consolidation and focuses on value and outcomes for members. As the Bill completes its passage through parliament, the engagement of industry with parliamentarians will be key to ensuring it is fit for purpose and achieves its stated intentions.

This will not, and indeed cannot, be the only legislative development in this space. With the first phase of a year-long pensions review underway, spearheaded by Pensions Minister Emma Reynolds MP, more legislation is to be expected in the coming years. In the meantime, as a new government and a new parliament settles in, parliamentarians will have an important role in the debate and scrutiny of the pensions landscape – and a steep learning curve. Master Trusts, Group Personal Protection Plans, single employer trust-based schemes will all be unfamiliar terms to many of the new parliamentarians.

Our whitepaper aims to shine a light on these parts of the market, the overall complexity of the pensions universe, and the practicalities and challenges of moving towards a more consolidated model, while keeping members best interests at heart.

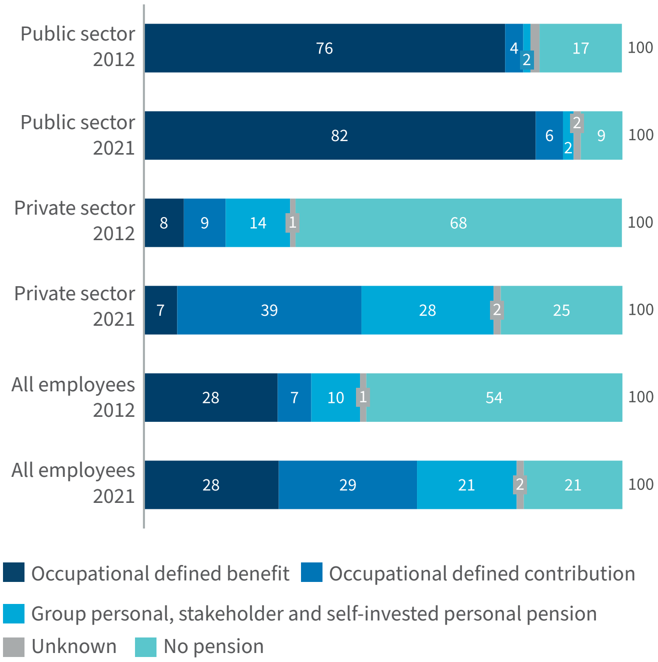
Group Personal Protection Plans (GPPs)

A group personal pension plan is a collection of personal plans which belong to the individuals. These are provided by an external company, usually an insurance company.

According to the Office for National Statistics, the number of private sector employees enrolled in either a group personal, self-invested or stakeholder pension plan more than doubled from 2012 to 2021 to 27.6 million from 13.6 million.

The gap in workplace pension participation between the public and private sector has narrowed since the roll out of the automatic enrolment

Proportion of employees with workplace pension by type of pension and sector, UK, 2012 and 2021



There are estimated to be around 300,000 GPP and group self-invested pension plans, says Maggie Kearney, director of defined contribution at Redington. However, many of those employers may no longer exist, she adds.

However, that does not mean the workplace personal pensions market is fragmented into lots of individual employer schemes all investing for themselves.

Andy Cheseldine, professional trustee at Capital Cranfield, notes that there are around 50 different providers offering GPPs to these 300,000 employers.

Of those 50 providers, however, there are around seven major insurers that dominate the workplace personal pension market and manage most of the assets, added Tom Barton, Partner at Pinsent Masons.

The major players include the likes of Aegon, Aviva, Legal & General, Fidelity, Phoenix Group, Royal London Asset Management and Scottish Widows.

These large players are open to new business and are very active in the auto-enrolment market, adds Barton.

“This market has already undergone significant consolidation because there have been so many mergers among the large players,” he says. For example, Phoenix has come together from the likes of ReAssure, Sun Life and Standard Life.

In many respects assets are already consolidated in the workplace personal pensions market, albeit there may be further measures to hold and invest assets more efficiently across each providers’ workplace book.

Tim Middleton, director of policy and external affairs at PMI, says: “There is less of an incentive to consolidate GPPs because they are already managed by these large personal pension providers.”

He adds, “as the contributions are then consolidated into a fund operated by the GPP which is not unique to the employer, there are already economies of scale and consolidation happening.”

Legacy Schemes

But while there will be economies of scale for those schemes which are used for auto-enrolment, there are legacy GPP schemes which may have defunct investment strategies.

Maggie Kearney, director of defined contribution at Redington, says: “Twenty years I was added to a GPP which still operates the same investment strategy as it did back then.”

We take a deeper dive into the types of legacy GPP schemes and the challenges of consolidating these later in the report.

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Consolidation benefits

This concentration of assets in fewer, larger schemes and providers can make it easier for the Regulators to have visibility, says Barton.

Consolidation also brings economies of scale and economies of investment to the workplace pensions market – enabling capital to be deployed in the sorts of ways now being proposed by policymakers, he says.

Cheseldine adds: "It's not unusual to see an Independent Governance Committee report where one GPP has more than 300 different default funds." That's an unhelpful number of default funds from governance, regulatory and value for members perspectives.

But while the workplace personal pensions market has already experienced consolidation, our industry experts believe there is still an argument for further forms of consolidation within the workplace market as a whole.

From a member's perspective, consolidation is helpful when it improves their retirement benefits rather than improving the profit margin of the pension provider.

Bringing asset management in house is one way to potentially reduce investment costs for members.

Liz Fernando, chief investment officer at Nest, says: "Managing assets internally can help to build a better alignment of interests and lower the cost base."

For example, once an internal investment team has been established, the cost of the team does not increase one-for-one as the assets under management grows, providing economies of scale.

Fernando says: "If a GPP is using an in-house product to manage a default scheme, that should create greater economies of scale and lower charges for members." The question is how much of these benefits get passed onto the members, she adds.

Zombie schemes

There is such a high volume of single-employer trust-based schemes due to individual employers wanting to develop their own schemes, in a similar manner to a defined benefit scheme.

Finding ways to consolidate these schemes is particularly difficult because they are all individually managed.

These legacy DC schemes came into existence long before auto-enrolment was introduced. In the 1980s and 1990s, the way defined benefit schemes were regulated started to change causing these schemes to be seen as expensive.

As a result, DB schemes started to be closed to accruals and new members with defined contribution schemes started to be opened. In addition, some employers preferred to offer DC rather than DB schemes, particularly the financial services and pharmaceutical industries.

Middleton says: "The biggest area of concern within the single employer trust-based market are 'zombie' schemes which were established during the 1980s where the sole investment would have been a with-profits fund and there is no longer a sponsoring employer."

Barton says: "Some of the issue is with executive pension plans which were sold to owner-managed businesses with the same individual acting as the trustee and the beneficiary / member."

Issues have arisen over time, as, in many cases, the trustee / beneficiary hasn't been equipped to run these products.

Barton says: “In these difficult instances, the insurance company often isn’t empowered to step in and takeover the governance, so important decisions are not being made.”

“This has created a situation where these schemes are lumbering on with no proper governance. “These trust-based schemes are the prime candidates for consolidation because they are not being properly managed.”

- **Tim Middleton**, Director of Policy and External Affairs at PMI

“These schemes are also the hardest to consolidate,” adds Cheseldine. It is very difficult to take people out of a with-profits scheme because it is difficult to know how much profit has yet to be allocated and how this can be distributed fairly.”

Time is also a major factor. If a member was more than 10 years away from retirement it would be easier to do but, Cheseldine points out that the nature of these schemes means that most members are only five to 10 years from potential retirement dates, making this much harder.

However, Barton noted that while “there are probably a large number of individual small schemes, the aggregate assets involved is not a large number in the grand scheme of things.”

But Cheseldine is less concerned about these with-profits schemes. As these investments were established by the member, it is up to them to manage them, he adds.

Cheseldine says: “The remaining 1,200 or so single employer trust-based schemes with five members or more are of greater concern.”

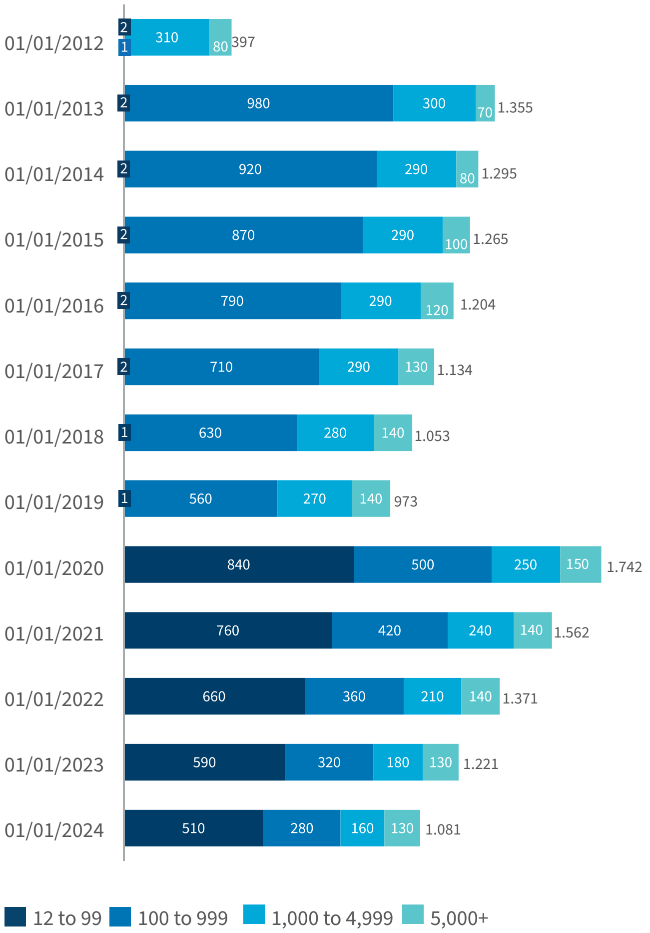
It is these schemes The Pension Regulator would like to consolidate, he adds. But the challenge with consolidating these smaller schemes is doing so within a timescale TPR is happy with.

Master Trusts

Much of the focus of consolidation in defined contribution pensions has been on master trusts, which began to take off in a new way with the introduction of auto-enrolment.

Fernando says: “By 2022, the number of master trusts had been reduced to around 36 with around 20 million members and around £79bn aggregate assets-under-management.” That reduction was from the original 100 master trusts.

OVERVIEW OF CURRENT MARKET LANDSCAPE



All our panellists agreed that further consolidation was naturally expected though.

Cheseldine says: "Given how it's measured, there will probably be 24 master trusts or fewer left by the end of this year." The three Cushon master trusts can be counted as one and two for Legal & General (relief at source and net-pay arrangements).

That 24 also includes 10 master trusts which cannot be consolidated because they are hybrid schemes, he adds.

Once again, however, most assets are already held in a few large master trusts.

The two largest master trusts are Nest and People's Pension which currently have assets of just over £40bn and £25bn respectively. Barton says: "Five master trusts have 82% of the members."

Warning bells were sounded on the pursuit of consolidation for consolidations sake though.

Sentiment around the table was clear that further consolidation should not be happening just for the sake of reducing the number of players in the master trust market – the quality of pension providers should also be improving.
Fernando says: "The higher quality players should be the ones growing their assets under management."

Kearney added that while the regulator seems to be very focused on further consolidation in the master trust universe, given that the top master trusts are already controlling most of the assets and many of the smaller master trusts may exist for very specific reasons or as part of a hybrid DB and DC benefit arrangement– the reality may be that there is not much room for further consolidation of this market.

"What we don't want to see is attention going to what essentially could be just a shuffling of the deck chairs from one provider to another, given how much consolidation we have already seen in this space. There are bigger issues that need to be addressed."

- **Maggie Kearney**, Director of Defined Contribution at Redingtonat PMI

Greater Investment in the UK

One of the biggest questions to unpick is whether consolidating defined contribution assets will also help the Labour government achieve its ambition of encouraging pension schemes to invest more in the UK.

While the government is keen to access pension scheme capital to bolster its public finances and boost growth, the pension system is designed to provide retirement income to citizens and ease the tax burden.

"Is it the role of the pensions system to act as financial backer to the UK economy?"

- **Tim Middleton**, Director of Policy and External Affairs at PMI

Middleton says: "Is it the role of the pensions system to act as financial backer to the UK economy?" The bottom line, pension schemes are not going to invest in UK assets unless they provide the right risk-return profile.

And from the government's perspective, while accessing pension scheme capital is a way to keep these investments off their own balance sheet, this will be a more expensive way to finance these investments than issuing sovereign debt.

Kearney says it is also a case of stick vs carrot. "If we look at Australia, which is often held up as a gold standard for domestic investment from its superannuation schemes, there were clear tax incentives to encourage the supers to invest in areas such as Australia infrastructure or Australian equities".

Private asset opportunities

Ultimately, while consolidating pension scheme assets into large pension providers does create the scale required for providers to allocate to the UK economy, panellists all agreed that investment strategy should be dictated by member needs – not political agendas.

Fernando says: "Nest has different building block portfolios which have different aims and ambitions depending on where the member is on their retirement journey."

For example, in the growth stage of the member journey, Nest allocates a larger proportion to private equity and would also like to add growth capital.

Fernando says: "Growth capital should be thought of as the stage between venture capital and private equity and this could be both in the UK and overseas businesses with UK operations."

UK early-stage venture capital is well served and there is not a lack of funding. Fernando says: "Companies struggle, however, to find sufficient capital once they start to grow and scale the business."

This is a better time for Nest to invest. "We feel nervous about the high failure rates in venture capital because our members do not have precautionary savings so permanently destroying capital is highly problematic," says Fernando.

In the growth stage, however, failure rates decrease as do growth rates but this risk-return profile is a better match for defined contribution members, she adds. "The ticket sizes are also bigger which helps us too," she says.

The other benefit of investing in growth capital is that it is a grey area between venture capital and private equity. "It's advantageous for us to invest in this grey area because there is less competition as it is less well defined," says Fernando.

Infrastructure equity can also play an important role in portfolios. "We do like being the equity investor in infrastructure because it gives us governance and stewardship and allows us to influence corporate strategy," says Fernando.

She adds that it is also important to consider potentially deep J-Curves on developments and how these can be navigated to ensure members are treated fairly, given differentials in who is contributing when.

"We have talked to government about helping us to lower the depth of the J-curve in exchange for giving up the unlimited upside of overstretching companies by loading them with too much debt," says Fernando.

That might work as way of getting stuff built through equity finance while avoiding extracting excessive returns from these investments which can damage public confidence in public-private partnerships, she adds.

For example, the recent water companies crisis has shown institutional investors the risks associated with regulated utility debt, she adds.

If Nest can find investments which not only provide the financial returns to provide its members with a good retirement that also helps to contribute to a growing UK economy which also creates jobs, then everyone benefits, she adds.

Best Consolidation Opportunities

Now we have taken a deep dive into the different parts of the pensions market, we can look at where consolidation would have the positive benefits for members.

Trust-based schemes

Kearney says: "We have a pension regulator who seems to be very focused on the supervisory regime for master trusts. However, I think the best opportunity is in the trust-based small schemes. There are around 1000 trust-based schemes with between 12 and 5,000 members, and around 25,000 with 2 to 11 members." These schemes may not be providing the economies of scale they could be providing which would benefit members.

Middleton agreed: "That's where most of the problems are in terms of providing value for members and there is very poor governance." It is difficult for the regulator to deal with these schemes. "These are the most pressing problem," he adds.

Workplace personal pensions

Barton adds: "Consolidation should mean more than just moving assets from one place to another. In some cases, it could more usefully mean modernising legacy products. However, legacy workplace personal pensions - group personal pension plans and others - are difficult to update and change because of contract law."

Trust-based schemes are becoming popular among commercial pension providers. "They are flexible, the members are more portable – it's much easier to make changes without the consent of individuals."

That is much harder to do for the workplace personal pension world because the individual owns and runs the product rather than a trustee. Barton says: "In this world, we lack the specific bulk change mechanisms that exist in trust-based schemes."

It is possible to implement some changes under current legislation. But that legislation is not really designed for the sorts of changes which may be required to consolidate/modernise legacy schemes. Barton says: "More specific bulk-change mechanisms could be introduced with the sorts of consumer safeguards we see used in trust-based schemes."

Rather than undoing the contract law which governs each individual agreement, powers could be created which allow for bulk changes to happen, subject to things like fairness and detriment and possibly independent review, says Barton.

"This would help to resolve complex legacy issues with charges, out-of-date investments, and out-of-date administration delivery," says Barton.

By enabling these bulk changes to be made, it makes better use of the scale providers already have and is probably well aligned with things like Consumer Duty objectives, says Barton.

Cheseldine says: "These issues could be dealt with if the regulator was hard-nosed and told schemes they were not fit for purpose and needed to change but they (TPR) need to be seen to be balanced and fair."

Future proofing

Over time, people retiring will be increasingly dependent on their DC pot to provide them with a sustainable income in retirement.

Fernando says: "Turning a DC pot into a retirement income is tough and requires complex decisions", pointing to economies of scale that can be achieved through consolidation, "so it is a big help if all the pots are consolidated in one place to ensure they are invested correctly to give you the retirement outcome."

Middleton agrees: "It's much easier for a member to turn a DC pot into a retirement income if there is only one fund rather than a half a dozen and it is also much more cost effective."

Again, the issue of legacy schemes was front and centre when it came to ensuring members pots were being invested in the best possible way.

For example, Fernando pointed out that if a scheme member has part of the DC pension pot invested in a legacy scheme which is not properly managed, it might well be invested entirely in equities just as that member was approaching retirement.

Fernando adds: "It would help if there was a quality-threshold that anyone who offered a DC pension or may act as a consolidator had to clear, which included not only a good investment strategy but strong governance and effective administration."

Impact of consolidation on the investment strategy

Nest is a good illustration of the advantages of scale. "When Nest first started and had few funds, it used pooled strategies in a handful of asset classes," says Fernando.

But as the size of the assets under management has grown, the investment team has gradually added more asset classes and moved out of pooled funds into segregated mandates, she adds.

"As the internal resource has increased, we have been able to blend the assets in a more sophisticated way," says Fernando.

Scale has also given Nest considerable negotiating clout, enabling the master trust to agree deals with private market asset managers that do not include paying performance fees, says Fernando.

As assets continue to grow, Nest is likely to take management of certain asset classes in-house.

Fernando says: "There is no pension scheme around the world with an AUM of £100bn which is entirely outsourced. Nest will have that scale of assets in the early 2030's."

As a result, the master trust is looking at what conditions would need to be in place internally to make in-sourcing successful.

Fernando says: "There are a lot of boring, but important operational mechanisms which need to be in place to make managing assets internally feasible."

There needs to be the volition from the organisation to commit that capital and then to be able to recruit and retain the right personnel, she adds.

Future Consolidation Challenges

While a patchwork of legacy schemes which could be more effectively managed must be addressed, the current system means we will also continue to create multiple small pension pots.

Middelton says: "Generation Z is expected to have 14 different jobs over the course of their working lives which means they will rack up different types of pension arrangement."

They might end up a with a mishmash of public and private sector pensions which could include both trust-based and contract-based arrangements, he adds.

Cheseldine says: "Two years ago there were 12 million small pots worth less than £1,000 and 4 million less than £100." Since that date, around 1 million to 2 million pots under £1,000 have been added every year, he says.

Taking Nest as an example, according to their latest accounts the master trust had 4.5 million active members and around 10 million deferred members. "Every year they add about 150,000 active members and a million deferred members," says Cheseldine.

While dashboards will help members to keep track of their different pensions, managing money in all these different pots will be not be most effective way to plan for a retirement.

With no system currently in place to stop the proliferation of small pots, there will need to be a mechanism for sweeping these pots up into one place.

Individuals may transfer their individual DC pots, either to the one operated by their new employer or an externally managed scheme, but it is much harder to enforce bulk transfers, says Cheseldine.

Relying on individuals to make transfers, however, is not an effective way to ensure these pots will be managed in the best interests of members as it relies on each member being aware of the issue and prioritising the transfer.

Kearney says: "My personal experience is transferring pots is not easy for individuals, even for people like me who understand and work in the industry." The transfer process can take up to 12 weeks and many pension providers don't operate call centres outside of nine to five from Monday to Friday.

Kearney says: "Even if someone is aware they need to consolidate their pension pots, it's hard to do if getting in touch with the provider is only possible during normal working hours."

"Some elements of The Pensions Bill will help with some of these issues but there is not one homogeneous categorisation of winners and losers."

- **Andy Cheseldine**, Professional trustee at Capital Cranfield

For a pot which is worth less than £100, the providers are losing money because they cannot charge a flat £ fee per member. "But for a pot worth between £100 and £500, the members pay nearly all the costs and are losing out, but that doesn't necessarily mean providers are profiting" says Cheseldine.

Even for pots worth up to £2,000 some providers are losing money. "This is a major issue which should have been solved a long time ago," says Cheseldine.

Given the inefficiency of relying on individuals to make transfers, there is a strong argument for making this an automated process, says Fernando. "Having a high-quality default consolidation process just makes sense," she adds.

One way to solve this is to resurrect Steve Webb's original suggestion of pots following members.

Barton says: "We have seen examples of some schemes being set up as consolidators that work on a pot follows member. Within their T&Cs they include a transfer declaration which gives them permission to find all the new member's other pension pots and transfer them into the new scheme. There are concerns with this!

"In some cases, the consolidator uses high risk / atypical investments. In some cases, it's not clear whether the members actually know they have chosen to consolidate by signing up to the product.

"Whilst it might get thwarted by the red / amber flag regime – it is an example of coordinating something along the lines of pot follows member.

"Going forwards dashboard should provide a more mainstream way of enabling consolidation of individual pots."

Sophie Mayall
Managing Director, Financials, FTI Strategic Communications

The reasons for consolidation have been well voiced by both politicians and regulators: bigger, more professionally governed schemes which have the scale and sophistication to invest in a broader array of assets – dovetailing neatly with the current and previous government's ambition to unlock pension capital in support of UK capital markets.

In pursuit of this agenda however the question needs to be raised as to how much politicians are taking the time (or in many cases are given the time) to understand and recognise the complexity of the UK pensions market. One issue raised by our panellists was the short tenure, and high volume, of UK pension ministers we have seen over the past few years.

Through facilitating this conversation and producing this paper we hoped to raise awareness of this complexity and the reality of moving towards a more consolidated market across different areas of the pensions landscape, as well as put one question front and centre 'how will this benefit the end member'.

What is clear is that there are obstacles that will need to be overcome, both in regards to fixing legacy issues of the past and those we are only just seeing fully emerge now, such as the proliferation of small pots created in a world where individuals will likely move jobs multiple times.

Our panellists were united though that the pursuit of consolidation cannot be for consolidations sake and that this should be done for the benefit of the member, not to fulfil a political soundbite.

To paraphrase one of our panellists, the pensions industry was not created to act as the financial backer of the UK economy, and nor should it be expected to.

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