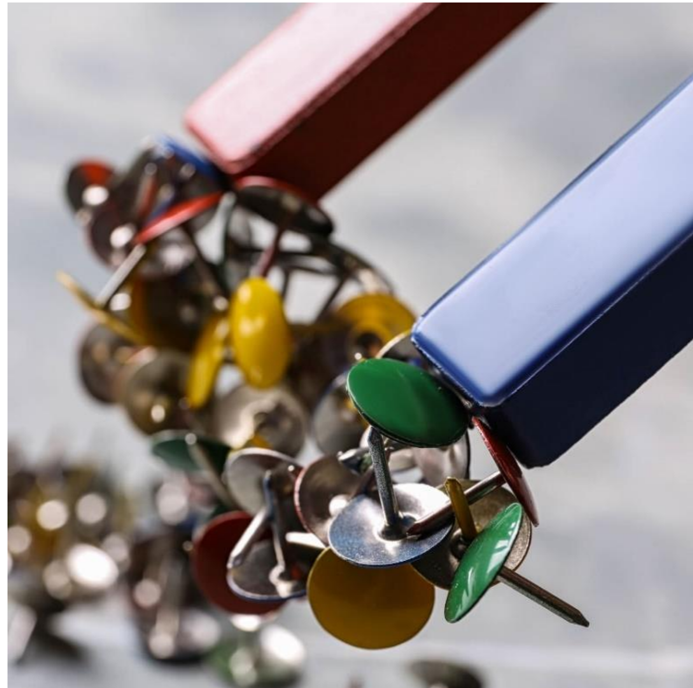
Magnetic Pensions – A new blueprint for the DC landscape

April 2024



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Executive Summary

- The proliferation of small and scattered pension pots is a blight on the pensions landscape. Savers may lose track of these pots or fail to combine them to make best use of them. And the rising cost of administering small separate pots is a drag on the pension system, wasting hundreds of millions of pounds a year.
- Our 'Magnetic Pensions' proposal tackles this problem and has several advantages over other solutions currently being discussed.
- Automatic Enrolment into workplace pensions has brought over 10 million people into pension saving. However, with every change of job, a new pension account is created, with the result that most individuals are likely to build up multiple pension pots over the course of their working life, some with very small amounts of money in them.
- The issue of small, deferred pension pots was anticipated when Automatic Enrolment was first established, though the scale of the problem was under-estimated. Latest figures suggest that there are currently around 18 million deferred pension pots of under £5,000, and two thirds of these are worth under £1,000.
- The DC landscape is extremely fragmented. Although a small number of very large Master Trusts dominate the market, there are over a thousand trust-based occupational schemes with more than a dozen members, whilst millions of workers are enrolled in workplace Group Personal Pension plans. Even where a member's career includes two or more workplaces which both use the same pension provider (e.g. the same Master Trust) they will often have two or more separate pension accounts with that provider, often with differences in charges and other product features.
- The Pensions Act 2014 gave powers to implement a 'pot follows' member system whereby a member's previous pension pot would automatically follow them to their new employer's scheme unless they opted out. This system was however never implemented.
- There has been no major legislation on small pots since 2014, though a minor legislative change was brought in from April 2022 to prevent very small, deferred pension pots from being eroded by flat fee charges.
- There has been a series of working groups and Government consultations since 2014 on small pots. A first priority has been to tackle 'micro' pension pots under

£1,000, with a firm proposal to sweep these up into one of a number of default consolidators.

- To try to prevent the creation of new small pots, more radical reform has been proposed by the Government. Proposals include giving workers 'member choice' over where their workplace contributions go and even trying to create a single 'lifetime provider' for a worker's entire pension savings. The Government has yet to respond to the latest consultation, but these proposals have generated widespread concern amongst consumer groups and industry experts.

- Objections have included the potential worsening of terms for ordinary workplace savers if higher earning colleagues opt to leave the workplace scheme, the challenges for members of identifying a provider offering value for money and the cost and complexity of the whole system. There would also be a risk that employers would no longer have an incentive to offer high quality workplace pensions. Workers can direct their pensions somewhere else) and this could undermine the high-quality provision that has been put in place in the last decade.

- In this paper, we propose an alternative way of tackling small pots which we believe would produce better outcomes for members. This builds on the 2014 'pot follows member' proposal but takes account of recent developments such as the proposed pensions dashboard, the increased focus on enabling DC schemes to invest in illiquid assets and the changing shape of the DC workplace landscape.

- Under our 'Magnetic Pensions' proposal, an individual's small DC pension pot would automatically move with them to their new workplace scheme when they change job, unless they opted out. But once pots had reached a reasonable level they would no longer be automatically moved. Having a modest pot size limit secures the benefits of consolidating small pensions but avoids eroding the value of larger pensions through repeated transfers.

- Key advantages of this approach include:

    - The idea of pension pots automatically following workers is relatively simple and, DWP research suggests, popular with the public.

    - A system of 'Magnetic Pensions' would help individuals to avoid the problems associated with small, deferred pension pots, such as losing track of pots or being disengaged because of the complexity of their pensions.

    - For many people, their main pension would be in their current workplace, where there is most likely to be guidance or advice around pension choices.

- Consolidating all small pots (not just ‘micro’ pots) would substantially reduce the ongoing cost of running the workplace pension system, and these cost savings can be passed on to members in the form of lower charges.

- Unlike ‘member choice’, our proposed solution retains all the advantages of a system where employers can negotiate a single high-quality pension for their entire workforce; ordinary members would get the benefits of consolidation without losing the cross-subsidy that they currently enjoy. And employers would continue to have an incentive to offer high quality workplace pensions.

- A system of ‘Magnetic Pensions’ could build on an enhanced dashboards infrastructure which will connect the vast majority of pensions to a single ‘hub’; this would save the significant extra costs that would otherwise be entailed by the Government’s plans for ‘micro’ pots and/or for a ‘member choice’ system.

- Unlike ‘member choice’, there would be no need for an explosion of marketing expenditure by providers looking to attract the pension contributions of top earners; there would also be no need for members to make sophisticated choices between different past pension schemes; members would, of course, remain entirely free to consolidate or move any of their ‘deferred’ pension pots at their own initiative if they wished to do so.

This paper is a call to the next Government to think again about the current direction of travel which risks creating a complex and expensive pension system which would not deliver for members. Magnetic Pensions offers a simple and efficient way of tackling small pension pots and improving member outcomes.

01 The Defined Contribution workplace landscape

To understand the nature of the problem of small and scattered pension pots, it is important to be clear about the types of pensions which people are building up in the workplace DC market.

The two main types[1] of workplace DC pensions are:

- 'trust-based' occupational pensions, overseen by the Pensions Regulator; and
- 'contract-based' workplace pensions, overseen by the Financial Conduct Authority.

According to the latest published data from the Annual Survey of Hours and Earnings (ASHE)[2], in 2021 just over 56% of workplace DC savers were active members of a trust-based occupational scheme, and around 41% were in a contract-based scheme, including group personal pensions and group stakeholder schemes[3]. This equates to just over 8 million workers building up new rights in occupational schemes and around 6.3 million in contract-based schemes. We consider each in turn below.

A. Trust-based Occupational DC Pensions

The latest data on occupational (i.e. trust-based) DC pension schemes was published by the Pensions Regulator (TPR) in January 2023[4]. Within this overall category there are two main types of arrangement:

- Master Trusts (MTs) which are multi-employer pension arrangements; and
- Single employer or 'own' trusts, where all members work (or worked) for the same employer.

Although TPR reports that there are nearly 27,000 occupational DC schemes, nearly 26,000 of these are tiny schemes with less than 12 members. These schemes would almost certainly be excluded from any process of workplace pension consolidation[5], so we

[1] We exclude other arrangements, such as Small Self-Administered Schemes (SSASs) as it is unlikely that these would fall within the scope of any automated consolidation proposal.
[2] Annual Survey of Hours and Earnings: summary of pension results - Office for National Statistics (ons.gov.uk)
[3] The remainder were coded as an unknown type of scheme.
[4] DC trust: scheme return data 2022 to 2023 | The Pensions Regulator
[5] These very small workplace schemes will include 'executive' pension schemes where it may be reasonable to assume a relatively high level of engagement and that high-quality arrangements will have been set up, often with the assistance of a financial adviser. With regard to other 'micro' schemes, the costs of setting up the infrastructure for automatic transfers are likely to be disproportionate and could fall on the member.

concentrate here on the remaining 1,220 occupational DC schemes of 12 members or more.

Having over 1,000 different DC schemes may seem like a lot of fragmentation, but consolidation of this market has been happening for many years. In particular, the number of schemes of 12 members or more has fallen by two thirds since 2012, with the drop particularly notable at the smaller end of the scale.

It is further worth pointing out that although most of these 1,220 schemes are relatively small, most people with occupational DC pension rights are not in a small scheme. This is because the main Master Trusts have millions of members each.

TPR statistics show that the overwhelming majority of workplace DC memberships are in schemes with 5,000 members or more, and most of these will be in Master Trusts due to the volume of their memberships. Note that these figures relate to 'memberships' of schemes and therefore includes both those who are actively contributing to a pension and those who have rights built up during a previous period but no longer being added to (known as 'deferred' pensions).

With regard to the growth in small pension pots, one important point is that it is possible for a member to have more than one pension with the same Master Trust, and it may not be a trivial matter to combine these into a single entitlement. The reason for this is that a Master Trust provider may quote different terms in different workplaces (e.g. offering a lower charge in a bigger workplace). This means that someone who is employed during their working life in two different workplaces where the same Master Trust is used can end up with two different pensions with different terms but with the same provider.

B. Master Trusts

Although Master Trusts (MTs) have existed for many years, the start of Automatic Enrolment in 2012 led to a surge in the creation of new MTs. The largest MT is the Government-backed Nest (National Employment Savings Trust) scheme, which currently has around 12 million active, deferred and pensioner members. But MTs are also operated by insurance companies, pension consultants or as free-standing trusts.

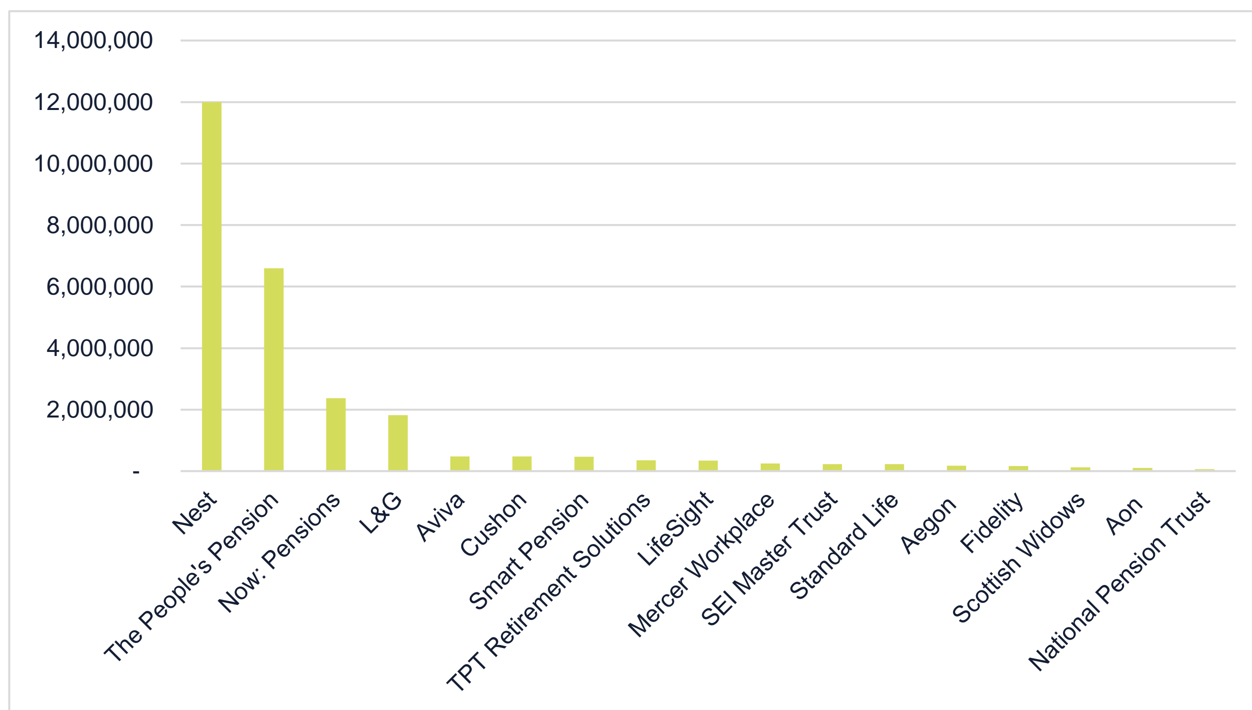
At one stage over 100 different MTs were registered with the Pensions Regulator. However, as a result of the 2017 Pension Schemes Act, a new Master Trust Authorisation Framework was put in place and this has resulted in a dramatic reduction in the number of MTs, with many smaller MTs either closing or being taken over. As of April 2024, the Pensions Regulator reports[6] that there were 35 authorised MTs in operation[7].

[6] https://www.thepensionsregulator.gov.uk/en/master-trust-pension-schemes/list-of-authorised-master-trusts

[7] Some of these are what have become known as accidental master trusts. They were not specifically set up to provide DC benefits to a wide range of unconnected employers but have simply been caught under the legal definition of a Master Trust and have, therefore, had to be authorised as such.

The relative size of different Master Trusts does however vary hugely. Figure 1 shows total membership data for the main Master Trusts.

Figure 1. Total membership of main Master Trusts, including deferred members



Source: Data supplied by schemes to LCP and published reports

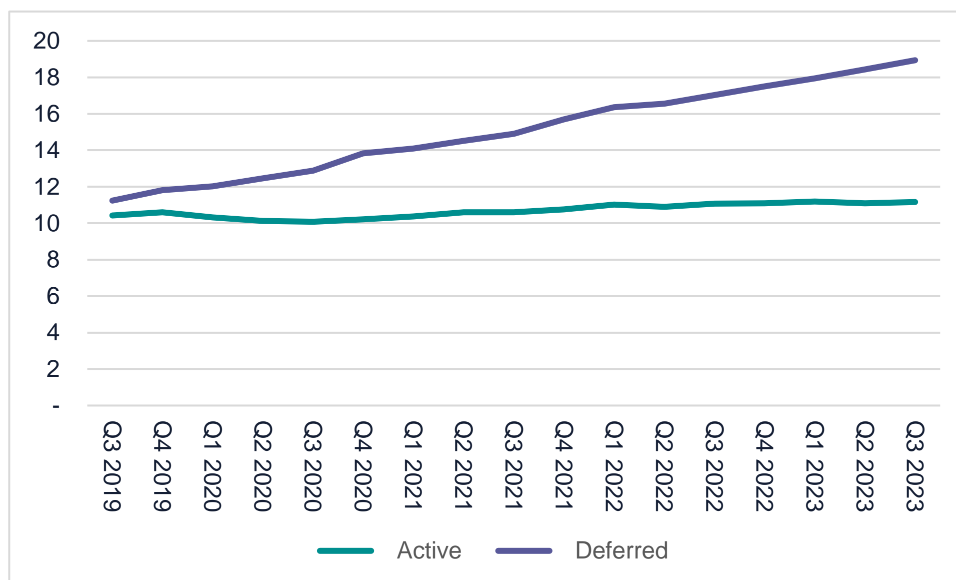
As noted earlier, the data in Figure 1 includes both those who are actively saving into a pension with the Master Trust in question as well as cases where that active membership has come to an end (through a job move, retirement or leaving the pension scheme for some other reason).

However, the balance between active and deferred memberships is shifting rapidly. Looking across occupational pensions as a whole, the Office for National Statistics publishes regular survey-based data on 'funded occupational pension schemes'. The latest figures[8] are shown in Figure 2.

As Figure 2 shows, in the third quarter of 2019 there were around 10.4m active members of private sector occupational DC pensions and around 11.2m deferred members. But just four years later, whilst active membership had risen 7% to 11.1m, deferred membership was up 68% to 19.0m. It is clear that a growing proportion of the pension accounts in the UK are now 'deferred' pots to which the member is no longer contributing, and this problem is rapidly getting worse.

[8] Funded occupational pension schemes in the UK - Office for National Statistics

Figure 2. Number of active and deferred DC pension pots (millions) 2019-2023



C. Single employer or own trusts

Before the advent of Automatic Enrolment, the most common occupational DC scheme was one run by a single employer for its current (and past) employees. In terms of the current market, TPR report that there are 1,220 occupational DC schemes with at least 12 members, but only 36 of these are Master Trusts. This leaves over 1,000 single employer trusts.

The nature of these single employer trusts varies greatly. At the upper end of the scale, over 100 single employer trusts have 5,000 or more members. These will tend to be those sponsored by household name employers and in some cases will have assets running into billions of pounds. In many cases the sponsoring employer will have taken the view that they want to provide something bespoke to their workforce and might be regarded as more 'paternalistic', being concerned not just for the current well-being of their employees but also their well-being in retirement.

The majority of single employer trusts will however be much smaller than this. TPR reports that around half have under 100 members, and there is currently considerable regulatory focus in trying to get these smaller schemes to consolidate.

For example, since October 2021 schemes with assets under £100m have been required to self-assess if they are able to provide value for money and to wind up or merge if they cannot. Recently published research[9] by TPR found that 1 in 6 of such schemes in a pilot study decided that they did not provide value for money and have opted to wind up.

This momentum towards consolidation in the single employer market is likely to be increased with the latest measures on Value For Money (VFM) announced by the

[9] Poor-value schemes are wound up as TPR takes tough action | The Pensions Regulator

Government in the 2024 Budget. Under these proposals, detailed VFM data will be gathered, and the poorest performing schemes will be prevented from taking on new business. It is likely therefore that the consolidation which we are seeing in any case in this part of the market will continue.

D. Contract-based workplace pensions

We turn now to the other main type of workplace pension provision – contract-based pensions. Unfortunately, whereas regular surveys are published of occupational DC schemes by the Pensions Regulator, much less data is readily available on the scale of memberships of group workplace arrangements regulated by the Financial Conduct Authority. We therefore need to rely on provider data and on other surveys to understand the nature of this market.

The ASHE data allows us to see how the size of the contract-based market relative to the trust-based market has changed since the introduction of Automatic Enrolment in 2012. The data can be seen in Figure 3.

Figure 3. Percentage of workforce actively saving in a) occupational DC pensions and b) contract-based pensions

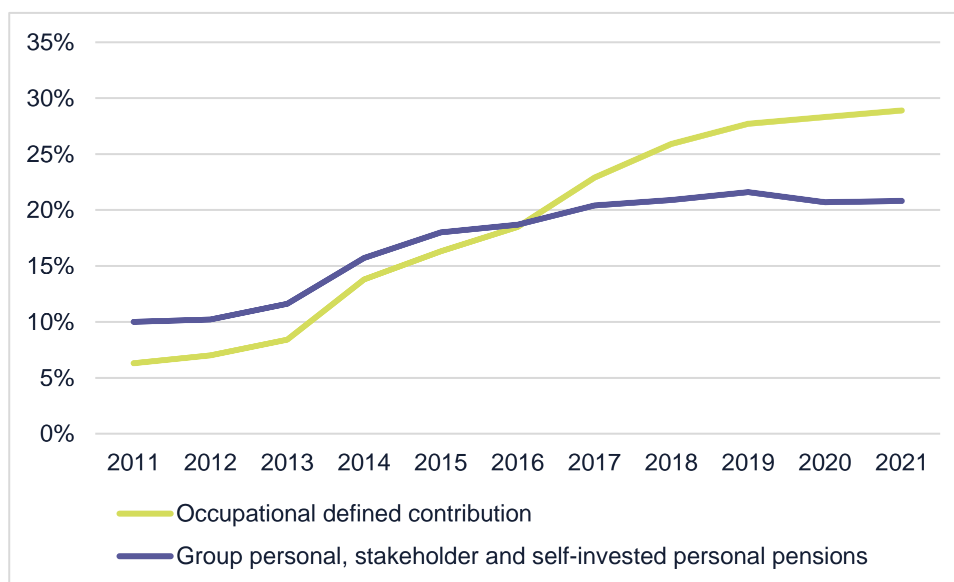


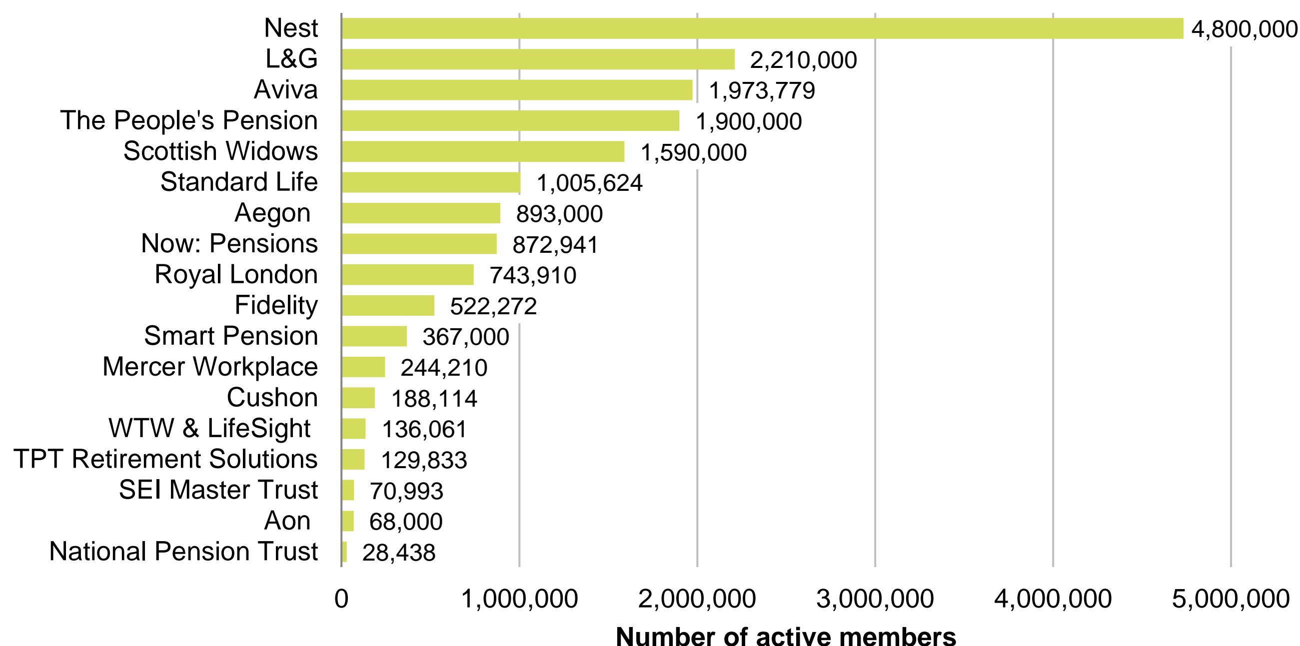
Figure 3 shows that at the start of Automatic Enrolment there were actually more people saving into contract-based pensions than occupational DC pensions. However, whilst the proportion of the workforce saving into contract-based pensions has doubled in a decade, the proportion in an occupational arrangement (mostly Master Trusts) has risen more than fourfold and has now overtaken the number in contract-based arrangements.

In terms of market shares, the contract-based world is somewhat less concentrated, not least because there is no single dominant provider in the contracted-based world equivalent to Nest in the trust-based world.

Because many insurers offer both a Master Trust and a Group Personal Pension, and separate data is not always available, the data that allows is based on the combined membership of Master Trusts and GPPs.

Figure 4 gives the total active membership of DC workplace pensions – both MTs and GPPS. It does not, however ,include single-employer schemes.

Figure 4. Workplace pension providers by number of active members



Whilst Nest remains the dominant player in the mass market, the inclusion of contract-based offerings means that insurance companies are key players, taking five of the next six places in this league table. The other large player is the People's Pension, whose membership has since passed the 2m mark.

A key point about this chart is to highlight the variety of providers of workplace pensions across different workplaces. A person moving jobs several times could easily build up several pensions across different Master Trusts and insurers and could also have multiple pensions with an individual provider, though possibly offered on different terms. It is easy to see how having multiple small pension pots across multiple providers has become commonplace.

02 Small pots – How many are there and why do they matter?

How many small pots are there?

The likelihood that Automatic Enrolment would lead to the creation of multiple small pension pots was foreseen at the start of Automatic Enrolment – but the scale of the problem was not.

As set out in more detail in the Appendix, as early as 2011, the Government published a consultation on the subject of 'dealing with small pension pots', and this estimated there could be 4.7m 'small' pots (under £2,000) generated by 2050. This consultation eventually led to legislation for a 'pot follows member' solution to the problem, which we discuss in more detail below.

As it has turned out, the scale of the small pots issue is much larger than originally thought. One of the main reasons for this is that before Automatic Enrolment (AE) started it was expected that around 1 in 3 of those who were enrolled would opt out, but the actual opt-out rate has turned out to be around 1 in 10. This fact, coupled with a growth in the overall size of the labour force, means that many millions more people are likely to be building up a small pension pot than previously estimated.

According to data supplied to the Department for Work and Pensions (DWP) by pension providers, the current situation is that there are around 18 million 'deferred' pension pots worth under £5,000 of which 12 million are under £1,000. These are pots which are 'left behind' when a member changes job and where there are generally no new contributions being added.

These figures will, of course, increase with every passing year, and especially if the scope of Automatic Enrolment is expanded – as planned – to bring in everyone aged 18+ rather than just those aged 22+. This age group is likely to have particularly high rates of job movement and therefore a higher risk of leaving behind a small pot after a short spell on a modest wage with one employer.

How much of a problem is this?

At one level, having your pension spread across multiple pension schemes and providers is not necessarily a big problem, at least not until you start thinking about accessing them. Pensions 'left behind' after you leave a job are not 'frozen' – they go on being invested, often in much the same way as they would have been if you were still contributing to them.

However, once we are talking about tens of millions of small pots, and typical workers having their pension wealth spread over multiple pensions, the case for addressing the problem becomes more pressing.

There are several reasons for this:

A. Deadweight cost

With particular reference to the very smallest pots – those under £1,000, often referred to as 'micro' pots – the administrative costs of running them can exceed the charge received by the pension provider. Certain costs, such as statutory member communications, can be the same whether a pot is £1,000 or £100,000, and things like call centre staffing levels will tend to be scaled in line with the number of members of a scheme rather than the size of pots. All of this cost could be regarded as 'deadweight' – if two £1,000 pots cost more to administer than one £2,000 pot, then the difference simply comes out as cost to providers and ultimately to members. If this cost could be taken out of the system, everyone would benefit.

Micro pots can actually be loss-making for the provider. Industry estimates supplied to DWP suggest a ballpark cost of around £20 per year to run a DC pension. But with a charge cap of 0.75%, even a pot of £1,000 will only generate charge revenue of £7.50. Consolidating these tiny pots would improve the financial health of the pension system as a whole.

B. Lost pots

If your pension is with a household name provider who has accurate and up-to-date information about you, then the fact that you are no longer adding to the pot should not mean that you lose it. But in reality, pension scheme data quality can vary hugely, and members often fail to notify all their pension providers of things like a change of address or change of name. With the passage of time, it becomes more likely that a deferred pension pot turns into a lost pot, whereas – in general – data quality and interaction should be much better for a current active pension pot.

Estimates of the value of lost pension pots vary greatly as there is no single standard definition. However, the Pensions Policy Institute (PPI) estimated[10] in 2022 the figure could be of the order of £27 billion, and that number is only going to rise over time without policy intervention.

One innovation which is expected to reduce the risk of lost pots is the forthcoming go-live of Pensions Dashboards. A Dashboard is a website or app where individuals can provide

[10] See: Briefing Note 134 - Lost Pensions 2022: What's the scale and impact? (pensionspolicyinstitute.org.uk)

their personal details and be 'reunited' with all of their different pension pots. Although the project has been much delayed, schemes have a final deadline of 2026 for connecting up to the Dashboards system and this should make matters much easier for consumers.

However, as noted earlier, a lot will depend on the quality of data. If a provider has an accurate NI number, date of birth and address for a member then there should be no problem getting a 'match' and the pension showing up on the dashboard. But if some of this data is missing or incorrect then there remains a risk that some of these pots may remain 'lost' to the member.

C. Erosion of pots

One particular challenge with regard to small pension pots is that the annual management charge could erode the pension if it is not being topped up. Although there is a cap of 0.75% on the charges on AE default funds, a small number of schemes apply a mixture of flat rate and 'ad valorem' (percentage) charges. A very small 'micro' pot could in principle be eroded to zero by the repeated application of flat rate charges.

In order to address this issue, the Government passed legislation[11] in 2022 which prevents schemes from applying such charging structures to pots under £100. However, whilst this should prevent pots from being reduced to zero, this does not fully remove the problem of small pots over £100 being eaten away as flat charges represent a much bigger proportion of the pot size than for larger pots.

D. Lack of engagement

Although Automatic Enrolment is based primarily on 'inertia', the new world of DC pension freedoms assumes that people will engage with their pensions and make well-informed choices in retirement. Given relatively low levels of financial literacy in the population as a whole, this is always going to be challenging, but if pensions are fragmented across multiple providers, each with a small pension, it is going to take a lot of engagement and effort for people to combine all of these pensions (if appropriate) and do something useful with them. A far more likely outcome is that they simply cash them all out – indeed, more than half of all pensions accessed at retirement are cashed out in full, and this proportion has not changed significantly since the start of Pension Freedoms in 2015.

Small pension pots are highly likely to be cashed out in full, whereas larger pots are more likely to be moved into drawdown and invested for longer. If an individual has a lot of small pension pots, a simple and tempting approach is to cash each one in, generating a useful lump sum each time. But if these pots collectively amount to a decent amount of money, it may well be better for the individual to go on investing into retirement, perhaps taking a tax free lump sum and moving the rest into drawdown. This is much less likely to happen if the individual first has to consolidate all of their pensions in one place.

[11] See: New rules to protect value of small pension pots laid in Parliament - GOV.UK (www.gov.uk)

03. *How is the Government planning to tackle the problem?*

Given the vast number of small pension pots already created and the millions more projected to be created, there has long been a case for regulatory action to address the problem.

The first such attempt in the Automatic Enrolment era was the 2014 Pensions Act which legislated for a system known as 'pot follows member', where pension pots from a previous job would automatically follow the member to their new job and be combined into the new job's pension scheme, subject to an upper limit on transfers. However, although the Primary Legislation for this proposal was approved, the necessary detailed regulations were never agreed, and a change of Government in 2015 meant that the idea was paused.

As described more fully in the Appendix, in the years which followed there was a lull in activity on this front and indeed no further substantive legislation has since been passed.

However, there have been multiple working group, reports and Government consultations, and current Government policy now has two main strands to address the small pots problem. These are first, action specifically designed to consolidate micro pots and second, more fundamental reform designed to prevent small pots from arising in future. In this chapter we describe what is proposed before explaining what we see as being the drawbacks with the current direction of policy.

Consolidation of 'micro' pension pots

The most pressing issue from the point of view of wasted administrative cost is the proliferation of very small pension pots. As noted earlier, the latest estimate is that there are around 12 million 'deferred' pots worth under £1,000 across the DC pension landscape.

Given the fact that a large proportion of these micro pots in the occupational pension sector are held by a small number of large Master Trusts, the industry has explored the potential for a 'member exchange' mechanism. Under 'member exchange', where the scheme holding a micro deferred pot could find another Master Trust holding the active pension for that member and could consolidate the micro pot into the active pot. This idea

is discussed in more detail in the Appendix, but this initiative has been paused partly because the Government is now proposing a more systematic and industry-wide approach and also because of challenges around implementing bulk pension transfers without the explicit consent of the member.

In order to address the problem of deferred micro pots, the Government has proposed a solution known as the 'multiple default consolidator' model. The key points of this proposal are:

- Only the smallest pension pots would be in scope; at present this is envisaged to be pots under £1,000, though that threshold could be increased if needed.
- Where someone changed job and ceased adding to such a pot it would at some point (e.g. after a year of inactivity) be treated as a deferred pot.
- A central clearing house or database would be notified by the pension scheme or provider of the existence of a new deferred pot associated with a named individual.
- The DWP would authorise a small number of providers to operate as a central home for these pots; deferred pots would be automatically moved (though with an opt-out right) to one of these highly regulated central providers; if the member then built up another small deferred pot somewhere else this would in due course be swept up and added to the same central consolidator scheme.

The legislation necessary to implement this solution has not yet been produced or passed, but the DWP does have a 'small pots delivery group' looking at how exactly all of this will work in practice.

Tackling the creation of new small pots – a pension 'pot for life'?

Whilst 'sweeping up' micro pension pots help to deal with the very smallest and least cost-effective pots, it would still potentially leave individuals with many slightly larger pots scattered across the pensions landscape. The Government has therefore also been exploring more radical reform – partly inspired by the system in Australia – which over time could mean that more people build up just one pension over their whole working life.

In November 2023, DWP published a consultation paper which sought views on the merits of two distinct – but closely linked – ideas for reform.

These were:

- 'Member Choice' – this would involve giving workers a legal right to tell their employer to redirect all pension contributions to a nominated scheme such as a previous pension held by the member; by contrast, under the current system in most workplaces workers have no choice as to the pension scheme they join – the employer chooses one (or sometimes more than one) pension provider, and all

contributions are directed into that scheme; the consultation assumes that the recipient schemes would have to satisfy various minimum standards, and envisages some sort of central 'clearing house' which would enable employers to pass over pension contributions (from both worker and firm) and redirect them to a nominated pension provider or scheme; and/or

- 'Lifetime Provider' – this slightly different proposition envisages a world where people could literally have a single pension provider which they use throughout their working life. This would be easiest to achieve for those entering the jobs market for the first time. The idea would be that having built up a first pension in a first job with a first pension provider, the member would by default continue to make contributions into that first scheme wherever else they worked. This concept is known in Australia as 'stapling'. There could still be an option for workers to opt instead for a pension scheme offered by their current employer, but those who only wanted a single pension and were happy with their first provider could remain in that scheme throughout their working life.

Problems with these proposals?

The Government initiatives set out in the previous section have some attractions. They could 'sweep up' millions of tiny pension pots, removing cost from the system. And they could provide a way for engaged pension savers to shop around for their workplace pension rather than simply take the one offered by their current employer.

However, we have serious concerns about this direction of travel.

Risk of poor member choices

Whereas consumer choice and shopping around can lead to good outcomes in retail consumer markets, choosing a pension is a much more complex choice. In particular, workers who do not have access to personalised financial advice may struggle to make the best choice as to where to direct their pension contributions.

To give an example, in choosing which previous pension pot should be the recipient of redirected contributions, a member may wish to consider the following (non-exhaustive) list:

- Level of costs and charges
- Past investment performance and potential future performance
- Whether the investment strategy is a good fit for the member's stage of life, needs and attitudes towards risk
- Whether there is a suitable post-retirement offering

- Governance standards
- Customer service standards
- Whether the money is invested with high Environmental, Social and Governance (ESG) standards
- The quality of service
- Communications and tools

Even someone financially sophisticated might struggle to assess a range of past pension providers against such a long list of criteria in order to decide the best home for their money. And making a balanced and informed choice may be particularly hard in an environment where there is a big marketing spend targeted at those with the largest pots. There is a real risk that the consumer, being overwhelmed by the complexity of the choice, could end up with the provider who has the best TV adverts or the smartest app. Or, in other words, there is no guarantee that people will redirect their money to the scheme which would give them the best outcome overall.

Impact on low- and middle-income workers who remain in the workplace scheme

The current system of workplace pensions depends in part on cross-subsidy – in simple terms, the revenue to a pension provider from the charges on people with large pension pots helps to subsidise the cost of providing pensions to low earners with small pots. If member choice is introduced, the financial services industry will be likely to seek to encourage those with large pots to switch their contributions away from the current workplace provider. If this marketing is successful, the economics of the workplace scheme for the remaining workers will be changed, and providers are likely to charge more for a scheme with fewer highly paid workers. In short, the exercise of free choice by those at the top could lead to worse outcomes for those in the middle and at the bottom.

Some evidence of this comes from research into pension scheme charges published by DWP in 2021[12] . This found that, particularly for single employer trusts and contract-based schemes:

"Larger schemes received lower fees, reportedly because employer costs for entry tend to be fixed, making larger schemes more economic per member and, secondly, having larger total funds often allowed larger schemes to leverage a lower ongoing charge."

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[12] See: Pension charges survey 2020 – summary - GOV.UK (www.gov.uk)

The second point is particularly important – a workplace with a large membership and a good number of high earners can be attractive to competing pension providers. This buying power means that the employer, on behalf of the entire workforce, can negotiate a good deal. If significant numbers of more engaged and well-advised high earners exercise their 'member choice' to go elsewhere, this changes the economics of the scheme that they leave behind.

Increased cost and complexity, leading to higher costs overall

The pensions industry is already meeting the costs of connecting to the UK Pensions Dashboards Programme and, under current plans, will end up paying for the creation of a new infrastructure for the automatic transfer of 'micro' pension pots. If Member Choice or 'Lifetime Provider' were to be implemented, there would then have to be another clearing house to enable employers to send the pension contributions of each of their employees to a nominated pension scheme.

Employers would also incur additional costs. Employers would need to find out from each employee where they wanted their contributions to go, communicate that information to a clearing house, administer these contributions individually and presumably deal with changes as workers decided to nominate a different pension scheme. This could potentially have a significant impact on HR teams, especially in workplaces where there is considerable staff turnover and a regular flow of new employees whose preferences would need to be established.

On top of all of this there would be considerable marketing costs which are largely absent from the current system, as pension providers would seek to lure the most lucrative savers away from their current workplace pension. These costs are a notable feature of the Australian system where, despite typically much larger schemes, average member charges are more than double those in the UK[13].

All of this infrastructure and marketing comes at a cost and there is no reason to think that this will be funded by the Government. It is highly likely therefore that it will be members who end up paying. And if top earners can shop around and apply price pressure to providers it is likely to be the remaining workplace pensions where cost pressures will turn into higher charges for ordinary members.

Given the serious concerns about the potential impact of such a change, the question then arises as to whether there is a better way to tackle the small pension pot problem. We believe that there is, and we set out our proposal in the next section.

[13] The Australian 'Productivity Commission' found that charges in Superfunds averaged around 1.1% in 2017, and more recent industry surveys have suggested similar figures (see: Overview - Inquiry report - Superannuation: Assessing Efficiency and Competitiveness (pc.gov.au)) This compares with an average of 0.48% for default funds in workplace schemes as report by DWP in its 2020 survey (see: Pension charges survey 2020 – summary - GOV.UK (www.gov.uk)).

04 Is there a better way? – Time for 'Magnetic Pensions'

The challenge we have set ourselves is to find a solution to the small pots problem which produces the best outcomes for members and avoids the downsides we have identified with the Government's strategy.

In particular, we focus on savers on middle and lower incomes – many of whom only started pension saving as a result of Automatic Enrolment. Most of this group is not saving enough for a comfortable retirement and particularly needs to make the most of their retirement savings. However, they are much less likely than higher earners to have the support of advisers to help them do so.

One solution, which found favour with a previous Government, was known as 'pot follows member'. In essence, the idea is that small pots move with you when you change jobs so that you gradually build up one (or a small number of) decent sized pots, rather than creating a lot of small pots.

That idea was included in legislation ten years ago (the Pensions Act 2014), but it was never implemented. But we believe that an updated version, taking account into things like the advent of Pensions Dashboards and the greater focus on how DC schemes invest their money, could be the best solution to the problem.

We refer to this updated version as 'Magnetic Pensions', conveying the simple idea that small pension pots are 'magnetically' attached to you as you move from job to job, though always with the option of leaving them behind if you wish. In this section we set out how such a system might work.

Magnetic Pensions – Key features

Under the present system, when an individual starts a new job, they will generally be automatically enrolled into the workplace pension chosen by their new employer. Their previous pension will not receive any more contributions and will become what is known as a 'deferred' pension.

As will have been apparent from our description of the DC pension landscape at the start of this report, it is likely that the new pension will be with a new pension provider, and this pattern potentially repeats itself with each new job move, leading to the creation of multiple – and potentially small – pension pots.

Even if the new employer uses a pension provider where the employee already holds an account, normal practice would be to create a brand-new pension account for the member. One reason for this is that the pension provider may have offered different terms (e.g. on charges) in the two different workplaces, and this can only be easily administered by operating two separate accounts.

These problems could be overcome if, instead, the first pension was 'magnetically attached' to the worker as they moved jobs, and the member's pot automatically transferred into the new pension scheme operated by the new employer. The worker would have the opportunity to 'opt out' if, for any reason, they preferred to leave their money where it was, but the power of inertia means that relatively few people would be expected to do so.

Some of the advantages of this proposal are:

- Workers would build up far fewer pension pots, reducing the risk of 'lost pots' and increasing the potential for member engagement with a smaller number of larger pots.
- The idea is relatively simple and easy for the public to understand; polling undertaken by DWP when options on small pots were considered in the run up to the Pensions Act 2014 found strong public support for the pot-follows-member concept compared to other options.[14]
- Implementing an automated transfer system of this sort would avoid the need for a wholly separate system to consolidate micro pots (and potentially another one to facilitate 'member choice'), which could result in a considerable cost saving.
- Matching workers and their pots, as they move jobs, is likely to be much easier now in a world where Pensions Dashboards mean the vast majority of pensions will be connected in a single 'ecosystem' than it was when this idea was first mooted a decade ago.
- This approach tackles the small pot problem without disrupting the highly attractive features of the current system, such as employers negotiating a high-quality pension on behalf of their entire workforce.

Which pensions would be transferred?

In implementing 'Magnetic Pensions', we envisage that the process would be introduced gradually, starting with the smallest pots, and only moving a worker's most recent past pot into their current pension scheme. The process could gradually be extended to cover all dormant small pots created since the start of automatic enrolment, and the pot size limit could gradually be increased.

[14] See Figure 2, gov-response-small-pots-automatic-transfers-consultation.pdf (publishing.service.gov.uk)

The main advantage of a comprehensive system of 'Magnetic Pensions', with a high pot size limit for transfers, is that much more consolidation would result. Individuals would be more likely to end up with a single pension or a small number of pensions with such a regime.

However, there are several reasons why there would need to be a pot size limit for this automatic transfer process, and why this might need to be set at a relatively modest level:

- Not all pension schemes are the same, and any automatic transfer system risks transferring from a 'better' scheme to a 'worse' one; this may be less important if it is simply a matter of tidying up scattered small pension pots but could be more significant if a large part of someone's pension wealth was being moved.[15]

- In a perfect world, pension transfers would happen with 100% accuracy based on perfect data, but the real world of pensions is unfortunately not like that; there is always a small risk that when an automated system moves money from one pot to another which appears to be owned by exactly the same person there could be a mismatch; any mismatch would be serious, but moving a large pension pot to the wrong place would be of particular concern.[16];

- To implement a pension transfer, DC pension providers would, based on current processes, need to sell the assets belonging to the member on the old pension arrangement, make a cash transfer, and then let the new pension scheme buy a new set of assets; the transaction costs involved could take a chunk out of the value of the pot, and a high pot size limit could result in repeated transfers with a chunk taken out each time.

- DC schemes might be reluctant to invest heavily in illiquid assets – even if this would otherwise be the best strategy – if they expected to have to liquidate holdings on a regular basis every time a deferred pot was transferred.

We do, however, think that some of these problems could be mitigated. As things stand, the majority of large DC Master Trusts are 'cashflow positive' – they have lots of working-age members paying into the scheme and relatively few older members taking money out. This inflow of liquidity could surely be used to facilitate the flow of assets from scheme to scheme with respect to deferred members without needing ceding schemes to sell assets whenever an automatic transfer is needed.

In short, there is a balance to be struck in terms of the scope of the Magnetic Pensions concept. Too low a limit would leave multiple deferred pension pots scattered across the landscape to the detriment of members. But too high a limit would increase the risk of

[15] It is possible that this concern could reduce over time if the government's 'VFM' agenda for DC pensions was successful in eliminating poorly performing DC schemes.
[16] It is to be hoped that the extensive data cleanse activity that may be associated with the Pensions Dashboards Programme will reduce this risk.

automatic transfers which were not in a member's interest and could generate unnecessary cost and 'churn' in the system.

We, therefore, advocate implementing this proposal incrementally and monitoring the impact on schemes and members before gradually expanding it. We believe a modest pot size limit is ultimately likely to be appropriate, but certainly one higher than the £1,000 figure proposed in the Government's proposals on consolidation of 'micro' pots.

05 *Implementing Magnetic Pensions*

As detailed in the appendix, a range of options have been considered over the last decade or more to address the various issues around small pension pots, and each option has its pros and cons. In this section, we discuss some of the issues that a 'Magnetic Pensions' solution would need to address and why we believe it offers the best overall solution.

Q. Doesn't 'Magnetic Pensions' mean money constantly moving around the system? Doesn't that undermine the drive for long-term illiquid investment by DC schemes?

As noted in the previous section, we think that there is a balance to be struck between consolidating pension pots as far as possible whilst not creating unnecessary 'churn' in pension scheme investments.

However, we think that there is a risk of overstating this problem and that pension schemes could find a way to take an automated transfer process in their stride without needing to disrupt their investment strategy through excessive holdings of liquid assets.

In a DC world increasingly dominated by a smaller number of large Master Trusts, a process of automatic transfer will, of course, lead to inflows and outflows between each scheme as workers change jobs. But what ultimately matters is simply the net balance of those transfers. In practice, it is most likely that schemes would simply transfer the net amount owing as a result of a round of job moves rather than for each scheme to sell all the pension assets of each worker who leaves and then start from scratch with each worker who arrives. This approach would greatly reduce the extent to which schemes had to hold excessive levels of liquid assets.

Q. What happens if someone's pension gets automatically transferred into an inferior pension scheme?

It is a feature of the pensions landscape that DC schemes may vary considerably in terms of their investment performance, charging levels, governance structures and so forth. There is therefore inevitably a risk that a pension which is magnetically attached to a worker when they change job could end up in a poorer value scheme.

Unless and until it is straightforward to assess whether one scheme is better than another this will be an issue for an automated transfer system but equally for a member choice system where members may struggle to work out which is the best pension and may inadvertently opt for one which performs less well.

This issue is clearly important, and could be an argument for a lower pot size limit on auto transfers, so that the gains from consolidation and engagement are more likely to outweigh any losses from inferior performance.

But obviously a better solution is to reduce the number of poor value schemes in the system. If the Government's VFM agenda is successful in levelling up standards and driving out the poorest performing schemes, concerns about transfers from 'good' schemes to 'bad' schemes should hopefully diminish. In addition, the 'Magnetic Pensions' scheme offers an explicit opt-out so that a member who is strongly attached to a previous pension which they know to be superior can simply opt out of the automatic transfer process.

Q. Would 'Magnetic Pensions' only apply to the most recent pot created? What about older pots?

We envisage that to get this new procedure up and running and to manage the initial volumes. It would be sensible to limit the process to transferring the small deferred pot created in the previous job to the new employer's scheme.

But, once the principle had been established, there is no reason why there could not be automatic transfers of a much broader range of small deferred pots – at the very least to include those created under the Automatic Enrolment policy.

Q. What about people who have more than one job?

There will be a relatively small number of people who have two or more jobs, each above the £10,000 threshold for Automatic Enrolment, and who have stayed enrolled in a workplace pension in each job. In this (presumably rare) situation, once the worker's 'old' pension pot met the rule for becoming a deferred pot (e.g. hadn't been added to for 12 months), a signal would be sent from the old scheme to the central eco-system to indicate that a deferred pot was now available for auto transfer, and the first of the member's new pension schemes to pick up that signal and indicate a willingness to receive that pot would receive it. It would probably add undue complexity to try to establish a priority order of the 'best' scheme for the member to automatically transfer into, but the member would, of course, remain free to reject the auto transfer and to manually instigate a transfer of the old pot if they wished.

Q. How would this proposal link to the Pensions Dashboard

One important respect in which the Magnetic Pensions proposal represents a development from the original ‘pot follows member’ idea is that we are now on the brink of having a Pensions Dashboards ‘ecosystem’, into which the vast majority of pension schemes are connected. This greatly simplifies the process of matching individuals and their pension pots as they change jobs.

One suggestion is that once someone has been in a new job for more than a year, their new pension provider would send a ‘search request’ to the pensions dashboard infrastructure – much as an individual member would do. This would send out a query to every connected pension scheme to establish if any of them holds a pot for the employee in question and if it meets the criteria for auto transfers – for example, pot value under a certain size, created since a certain date, etc. If the employee had a previous pension with one of these schemes, a match would be signalled. The new scheme would then notify the member that, unless they opted out, their old pension would be transferred across and combined with their new pension.

One big advantage of this process is that it puts very little burden on employers. The ‘receiving’ scheme has an incentive to undertake this process as it will acquire pension assets, and the ‘ceding’ scheme has an incentive because they will be able to get rid of the smallest (and potentially loss-making) pots.

06 Conclusion

More than a decade on from the introduction of Automatic Enrolment to workplace pensions there is still no mechanism in place to prevent the proliferation of small, deferred pension pots.

The very fact that it has proven so hard to come to a solution is an indication that this is a complex issue and there is no single 'silver bullet' policy response which commands consensus. As this paper has indicated, all the different options have their pros and cons, and none would be straightforward to implement.

However, we have written this paper because we believe that the current direction of policy is not in the best interests of members. The plan for a combination of 'multiple default consolidators' to sweep up micro pension pots and some version of 'member choice' to move towards a lifetime pension provider has some attractions. But it has more drawbacks including:

- Potentially making the pensions landscape much more complex and involving considerable extra cost; this would include creating a new clearing house for micro pots and another for employers to use to re-direct the pension contributions of their active employees, over and above the costs of the pension dashboard infrastructure; these costs will eventually be borne largely by members.
- Potentially bringing large marketing costs into the workplace pension world, as competing providers seek to lure the most lucrative pension savers into choosing them as the home for their workplace pension contributions.
- Undermining the collective nature of current workplace pension provision, almost certainly to the detriment of those with average and lower earnings, who currently benefit from a cross subsidy from the charges on the pension pots of higher earners.
- Relying on consumers to make sophisticated financial decisions about the relative merits of different pension providers, which they may be ill-equipped to make.

Instead, we advocate what we have called 'Magnetic Pensions', a reform that would build on the 'pot follows member' previously included in the Pensions Act 2014 but never implemented.

Under this approach a member's pension pot would automatically transfer with them when they change job. This process would be subject to a modest upper limit on pot size (to be kept under review) and a member opt out, where the member could decide that the money should stay where it is.

In our view, this approach would have the following advantages:

- It could take the place of having separate systems for clearing up micro pots and for member choice or a lifetime provider model.
- It would enable members to build up meaningful pension pots but without undermining the many advantages of having a single pension provider per workplace.
- It will improve member engagement with pensions as each member builds up a smaller number of larger value pots, including one in the current workplace where they are most likely to be able to access workplace guidance and information about their pension.
- It would avoid the extra costs entailed by having a 'retail' focus in workplace pensions with competing pension companies boosting their marketing budgets to attract high-value/high-earning pension contributors.
- It is a relatively simple idea and one which tests well with the public.

The start of a new Parliamentary term seems to be the right time to review the direction of pension policy and, in particular, to review whether the current strategy is correct. We believe that 'Magnetic Pensions' would reduce the risk of lost pension pots and improve member engagement and outcomes, but with much less upheaval to the whole system than alternative proposals. It is time to address the proliferation of small, deferred pension pots, and this is the best way to do it.

Appendix

Pension policy rarely starts from a blank sheet of paper, and this is particularly true in the case of policy around small pension pots. Even before the first person in the UK had been automatically enrolled into a workplace pension, policy makers were aware that a side-effect of AE was likely to be a large growth in the number of small, deferred pension pots. In this section we briefly summarise how policy in this area has evolved.

Phase 1 – the road to 'Pot Follows Member' – 2011-2015

In December 2011, the Government published a report[17] entitled "Meeting future workplace pension challenges: improving transfers and dealing with small pension pots". It anticipated that a combination of millions of people being automatically enrolled and then changing jobs would lead to a proliferation of small 'stranded' pension pots. The following is from the Ministerial foreword:

> *"With regard to small pots, the case for reform in this area is clear: as a result of Automatic Enrolment and high job churn, there could be up to 4.7 million additional small pension pots in the system by 2050."*

As we will see later, this figure turned out to be a massive under-estimate.

The paper identified a number of problems with a growing number of small pots:

- For pension providers, managing large numbers of small pots was seen as a 'huge burden'. It was noted that at an aggregate level it was inefficient to have multiple pension providers managing multiple small pension pots for the same individual.
- For the individual, problems included:
  - Higher costs, as providers passed on the cost of running a complex and inefficient system.
  - Making it more difficult for individuals to act and make choices about their pension position.
  - Being unable to buy a value-for-money annuity[18] with a small pot.

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[17] Meeting Future workplace pension challenges (small pension pots) - Cm 8184 December 2011 (publishing.service.gov.uk)

[18] Note that this document was written before the announcement of 'pension freedoms' which relaxed the rules on purchase of annuities from DC pension pots.

- People may not bother to keep track of small pots.
- Charges could be higher on ‘deferred’ pension pots (though the practice of applying higher charges to deferred members – known euphemistically as ‘active member discounts’ – was subsequently banned).

The paper consulted on three main options:

- Relatively minor changes to the ‘voluntary transfer system’ to make it easier for people to move their own pension pots around.
- Consolidation of small, deferred pension pots into one or more ‘aggregator’ schemes (this proposal foreshadowed the current policy of having ‘multiple default consolidators’ for the smallest pension pots)
- Automatic transfers – widely known as ‘pot follows member’ – where pots below a certain size would follow a member when they changed jobs unless they opted out.

It is worth saying that the paper proposed one additional measure which would actually increase the number of small pension pots. At the time it was common practice for people who had been a member of an occupational pension scheme for less than two years to apply for a ‘short service refund’, which allowed the member to recover their contributions. This practice would subsequently be banned.

In July 2012, the Government published its response[19]. This indicated that the balance of responses had been in favour of automatic transfers via the ‘pot follows member’ mechanism but acknowledged that a lot of work would be needed to develop a workable solution.

By April 2013, the Government was ready to commit to the ‘pot follows member’ route and published a White Paper[20] setting out more details. By this time, the document was talking about “50 million dormant pension pots” created under Automatic Enrolment by 2050. Notably, it was envisaged that this process would apply to all deferred pension pots worth under £10,000 but would initially only apply to pots created ‘after a certain date’ – that is, after the start of Automatic Enrolment. Consolidation of other small, deferred pots would come later.

The legal power to implement this policy was contained in the Pensions Act 2014, which received Royal Assent in May 2014.

[19] gov-response-small-pots-automatic-transfers-consultation.pdf (publishing.service.gov.uk)

[20] automatic-transfers-consolidating-pension-savings.pdf (publishing.service.gov.uk)

Phase 2 – ‘policy paralysis’ – 2015-2020

Passing an Act of Parliament is only the first stage to creating a legal framework for the implementation of a new policy. An Act gives a general direction and empowers the Government to bring forward more detailed ‘secondary’ legislation, which sets out exactly how the new process will work.

Unfortunately, a change of Government in 2015 meant that the momentum behind action on small pots was lost. Many other pensions issues needed to be addressed, including things like the regulation of Master Trusts to be used for Automatic Enrolment and the reform of DB funding following recent scandals.

It seems that it was felt that dealing with small pots could be put on the back burner on the basis that it would not be until 2019 that the process of enrolling all workers and scaling up contributions to the 8% minimum would be complete.

Phase 3 – ‘re-engagement’ 2020-2023

In September 2020, the then Pensions Minister set up a ‘small pots working group’, led by DWP but bringing in expertise from across the pensions sector, to consider how best to tackle this growing issue.

At the same time the Pensions Policy Institute (PPI) published a helpful briefing document[21] entitled “Small pots – what they are and why they matter” designed to inform the work of the group. This report provided an updated list of concerns about the growing number of small, deferred pension pots:

- They could be eroded or even reduced to zero because of certain (flat-rate) charging structures.
- They could be too small to ‘contribute meaningfully’ to retirement planning.
- They are more likely to be ‘lost’ over time.
- They are highly likely to be cashed in rather than ‘put towards retirement income products.’
- For providers, the cost of administering a growing number of such pots could undermine their financial stability, especially if flat fee charging structures were eliminated[22]. A pot size of £4,000 was estimated to be a ‘break-even’ pot, based on an annual management charge of 0.5%.

The early government work on small pots was done before Master Trusts became the dominant players in the Automatic Enrolment landscape. However, the PPI report notes that “the master trust universe holds the majority of small, deferred member pots” and bases its analysis largely on data from that group of schemes. At that point, it was estimated that there were around 8 million deferred pension pots in Master Trusts and that this could rise to around 27 million by the mid-2030s.

[21] 264178 PPI AE online booklet v3.indd (pensionspolicyinstitute.org.uk)

[22] The Government subsequently legislated to ban ‘flat fee’ charging structures on pots of under £100.

The PPI noted the following main policy solutions:

1. Pot Follows Member, possibly complemented by a ‘member exchange’ mechanism where schemes ‘trade’ pots periodically and move historic pots into the current active scheme. A potential downside was noted of the risk of pots being (automatically) transferred to a poorer quality scheme.

2. Lifetime scheme, which could cover a range of models such as members staying with the first scheme that they join (now known as ‘stapling’) or for all deferred pots to be sent to a pre-chosen scheme. It was noted that these kind of approaches would involve more fundamental reform and risked ‘cherry picking’ as providers sought out ‘more profitable-seeming employees.’

3. Consolidation of pots within schemes – arguably this could accompany either of the other two reforms; this involves making sure that where a member has multiple jobs with companies who each used the same pension provider (but possibly with different terms and conditions) the member ends up with a single entitlement with that provider rather than multiple separate pots.

In December 2020, the small pots working group published its first report[23], with a particular focus on the growth of small pots among Master Trusts. One key priority identified was for the industry to look at ways of reducing the cost of transfers, given that most solutions to the problem of small pots involve moving such pots to something bigger.

With regard to Master Trusts, the report presented the results of a DWP data gathering exercise in August/September 2020 which found that there were 11.2 million deferred pension pots. Of these, almost three quarters (74 per cent) were smaller than £1,000 whilst a quarter (25 per cent) were smaller than £100.

This was followed up in September 2021 by the first report[24] from an industry-driven ‘small pots cross-industry co-ordination group’. Notably, this group reinforced the point made by the previous working group that:

> *“Until a low-cost, at scale transfer system is available, a legislative solution implementing a mass scale consolidation system will not be possible.”*

[23] Small pots working group report (publishing.service.gov.uk)

[24] Small-pots-cross-industry-co-ordination-group-update-report.pdf (plsa.co.uk)

This report was produced at a time when work on the proposed Pensions Dashboard had started to gather momentum, and it noted the potential synergies between the two projects:

> *"Co-ordination between the Small Pots Co-ordination Group and the Pensions Dashboards programme [is needed] to explore opportunities and challenges of closer alignment; particularly learnings from data matching and data standards."*

The report went as far as recommending "focusing resources on getting the Pensions Dashboards core eco-system set up and running, rather than diverting attention to Small Pots requirements."

The second report[25] from the industry group was published in June 2022. This noted that whilst progress could be made on 'member-initiated' consolidation, this would be 'unlikely to materially reduce the number of small pots.' It added: "Only the implementation of a market-wide automatic transfer solution (or solutions) will make a material difference in reducing the number of deferred small pots currently in existence and preventing the ongoing proliferation of small pots in the future."

DWP, unfortunately had made it clear that it was looking for 'non-legislative' solutions which meant that any form of 'automatic' transfer solution was unlikely to be implemented in the short term.

However, a new Pensions Minister was appointed in late 2022 and in January 2023 published[26] a new 'call for evidence' on 'addressing the challenge of small pension pots.'

This report flagged that:

- The industry working group estimated that the 'waste' in administration costs in running small, deferred pension pots amounted to around one third of a billion pounds.
- The PPI estimate that the value of 'lost' pension pots had risen sharply from around £19bn in 2018 to nearly £27bn in 2022.

[25] Small-pots-co-ordination-group-spring-2022-report.pdf (abi.org.uk)

[26] Addressing-the-challenge-of-deferred-small-pots-a-call-for-evidence.pdf (publishing.service.gov.uk)

The call for evidence asked for views on:

- The maximum size threshold that should be used to define 'small' pots (offering options in the range of £1k-£10k).
- Whether there should be a minimum pot size, perhaps with a separate solution for 'micro' pots.
- How to define when a pot becomes 'deferred'.
- Whether a different approach should be taken for the 'stock' of existing deferred pots and the 'flow' of (potential) new deferred pots.
- The pros and cons of two main models:
    - The 'default consolidator' approach (with different variations such as single v. multiple consolidators, whether consolidation would be into a member's first scheme, etc).
    - 'Pot follows member'.

Whilst noting that no solution is perfect, the report highlighted some of the challenges around any solution, including:

- What should you do about 1m plus 'multiple job holders' who may have active pensions with more than one employer?
- What to do about people who change jobs especially frequently and whose deferred pot 'may never catch up with them' in a pot-follows-member model?

Member Exchange

The January 2023 consultation included a discussion of the 'Member Exchange' concept. The basis for identifying pots in scope was described as below:

> *"Under this model, pension providers would use a trusted third party pseudonymised data service to conduct a regular exercise and identify 'matches,' where they hold a deferred small pot for a member and another provider has the same individual as a member making active contributions into another pot..."*

DWP welcomed initiatives by the main Master Trusts to explore the scope for identifying members in common between them and the potential for 'exchanging members' so as to consolidate these multiple small pots with a single current provider. This would be worthwhile in its own right, as it would reduce the number of small, deferred pots, but could also provide lessons for any larger-scale process of automatic transfers.

Some of the barriers to moving ahead with this approach are likely to include:

- Consent issues, as this would have to be a transfer without seeking individual member consent.
- Other legal issues, including whether sharing data in this way contravenes the Data Protection duties of schemes.
- Whether actions by a closed group of schemes (e.g. large Master Trusts) to streamline their pension books in this way could be seen as anti-competitive.

Even leaving aside legal concerns, the issues around a member exchange process mirror some of the wider challenges for any form of automated transfer. These include:

- How would differences in charging structures / charging levels be handled?
- What about differences in investment approach (e.g. if schemes differed in the extent to which they took account of environmental, social and governance considerations)?
- What would be the process if a member said that they were unhappy after the event with a transfer that had gone ahead?

Phase 4 – Decisions and radical reform proposals 2023- to date

In July 2023, DWP published its response[27] to the January 2023 consultation. It said that there had been arguments for and against both of the main options under consideration. In the end, it had rejected the pot follows member approach for three key reasons:

- The risk of 'member detriment' if a member was transferred from a well-performing scheme to a poorly performing scheme.
- The potential impact on scheme investment strategies (and their willingness to hold illiquid assets in particular) if there was a large volume of money moving around the pension system.
- The risk of medium-sized pots getting trapped – being too large to be caught within the pot-follows-member regime but too small to be useful.

On balance, therefore, the Government came down in favour of a 'multiple default consolidator' model, with small, deferred pension pots being automatically transferred to one of a number of highly regulated and centralised pension schemes. An 'implementation group' has now been established to work out how this would all work in practice.[28]

The report also provided new data based on a survey of providers going beyond the Master Trust sector. The results are summarised below and suggest that the scale of small, deferred pension pots was probably even greater than had previously been thought.

[27] Ending the proliferation of deferred small pension pots-consultation (publishing.service.gov.uk)

[28] Efforts to tackle small pension pots step up a gear - GOV.UK (www.gov.uk)

Table 2: Cumulative number of deferred pots and assets below proposed limits

Pot Size	Below £1,000	Below £2,500	Below £5,000	Below £10,000
Number of Pots	12.1m	15.9m	18.2m	19.9m
as a % of Deferred Pots less than £10,000	61%	80%	91%	100%
Value of Assets	£4.2bn	£10.2bn	£18.0bn	£29.4bn
as a % of Assets in Deferred Pots less than £10,000	14%	35%	61%	100%

Source: Provider data from Call for Evidence

Stemming the inflow of new small pots

Whilst an automatic mechanism for sweeping up micro pots will help to deal with the ‘stock’ of tiny pensions, it will do little to address the steady inflow of (slightly larger) small deferred pension pots. At the same time as firming up its plans for micro pots, the Government, therefore, floated some more radical reform proposals designed to move towards a world where workers would ultimately have a single pension pot at the end of their working life.

The November 2023 consultation[29] proposed two different but related ideas:

- Member choice, where individuals could instruct their employer to divert employer and employee pension contributions to a pension scheme of their choice (rather than to the employer chosen scheme).

- Lifetime provider, where – perhaps for young people entering the workforce - pension contributions would by default be redirected to the first pension scheme which a member joined, building up a single ‘pot for life’; employers might still have to offer a pension to their active employees however, and the worker would be free to choose that scheme in preference to their first pension scheme.

DWP has yet to publish its response to this consultation, but it would be fair to say that widespread concerns have been expressed about these proposals. Having been announced to great fanfare in the November 2023 Autumn Statement, the language used in the March 2024 Budget was notably cooler, talking simply about ‘exploring’ these options and wanting first ‘to be sure’ that they would be to the benefit of members.

[29] Looking to the future: greater member security and rebalancing risk (publishing.service.gov.uk)

LCP powering possibility

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