ASSOCIATION OF CONSULTING ACTUARIES
First Floor (129) · 40 Gracechurch Street · London · EC3V 0BT
Tel: +44 (0)20 3102 6761 · Email: acahelp@aca.org.uk · Web: www.aca.org.uk

Submitted via email to:
pensions.investment@dwp.gov.uk

29 July 2021

Call for Evidence: Future of the defined contribution pension market: the case for greater consolidation

I am writing on behalf of the **Association of Consulting Actuaries (ACA)** in response to the above-named call for evidence.

The ACA is the representative body for UK consulting actuaries. Our members are all qualified actuaries, mainly Fellows of the Institute and Faculty of Actuaries. Members provide advice to thousands of employers and pension schemes with assets exceeding £1 trillion, including most of the country's largest schemes as well as thousands of smaller arrangements.

Our comments on specific questions raised in the consultation are set out below.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 07557 031198 or at tessa.page@mercer.com.

Yours sincerely

Tess Page
Chair, Defined Contribution Committee
On behalf of the Association of Consulting Actuaries Limited

Association of Consulting Actuaries (ACA) response

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

   We agree that this is an appropriate aim. However, we do not agree that schemes should be required to consolidate, or nudged down this path, *if* they are well governed and consistently able to demonstrate that they deliver good value for their members.

   One key risk with having fewer larger schemes is that this could lead to a race to the bottom in terms of costs, with a knock-on effect on the range and quality of investments, member service and experience. Lack of competition could hinder innovation and impact member outcomes.

   We believe that government should focus on those schemes that do not deliver good value, irrespective of size. We also support development and adoption of common value for members assessment principles and believe that these should be established, and reviewed by government (in consultation with industry), at regular intervals to re-set the baseline relative to changes in the DC landscape. It is too easy to draw a "positive" conclusion on value for members because of the flexibility in the method, tools, data, and process used to assess value.

2. *A. What impact will the new value for members assessment have on consolidation of schemes under £100m?*

   We expect that the new prescribed value for members assessment will provide trustees with more insight, more frequently, as to how their costs, charges, and net investment performance compares relative to known larger schemes; and where possible, schemes are likely to investigate the merits of consolidation.

   We expect the pace at which this happens to be fast i.e. within the next couple of years after the first prescribed assessments have been completed. That said, we also expect a lower percentage of these schemes to consolidate than may have been envisaged by government and industry. The main reasons include scope, barriers and decision making powers:

   - The draft regulations apply the £100m threshold to all assets in hybrid schemes. For many of our representative firms, we estimate that this reduces the number of schemes captured by the prescribed VFM basis by over two thirds.
   - Of those schemes captured, many have known barriers to consolidation, such as guaranteed minimum pension underpins or reference scheme test benefits.
   - Selection of a new vehicle and its implementation is a significant project that demands resource (both time and money). Where resources are constrained and the employer is unsupportive or unengaged (see below), this will be a challenge.
   - A change in vehicle is a decision that sits with the employer as opposed to the trustees, and there is no requirement on employers to consider consolidation in light of poor value. There is also no requirement for trustees to share a value for members assessment with the employer (or to consult on its conclusions), meaning that engagement with the employer relies on appetite from both parties.

2. *B. If you were a scheme that did not pass the value for members assessment, would you look to "wind up" or "look to improve" and how would you go about this?*

   This will depend on the circumstances of the scheme and its ability to wind up.

   If there are barriers to consolidation, especially guaranteed minimum pension underpins or other features of the benefit structure (such as the reference scheme test), we expect schemes will look to improve their value for member proposition as a first step, the rationale being that there may not be a consolidator option and the cost of buying out underpin benefits (if feasible) may be prohibitive.

A "seek to improve" first approach is likely to be the most common outcome for many schemes – see our comments in Q4 regarding the barriers to wind-up.

2. *C. Beyond the value for money assessment, could government, regulators and industry accelerate the pace of consolidation for schemes under £100m?*

We have not yet seen the first schemes go through the prescribed value for members assessment and so it is unclear how schemes will respond. Our view on the pace of consolidation is given in our response to Question 2a. However, we have set out below some areas that we believe could serve to further accelerate the pace of consolidation:

- Reporting to Members: government introducing a legislative requirement that schemes provide members with details of the value for members assessment. Although some of this detail is set out in the annual Chair's statement we do not believe this has far enough reach or provides sufficient information for members to fully understand its purpose. This might be particularly helpful for deferred members comparing legacy pension arrangements.
- Reporting to TPR: we acknowledge that schemes will be required to report on the value for members outcome in their scheme return, however the expectation of many schemes may be that TPR will not intervene where it is reported that value is delivered to members. Although there is guidance to support schemes with their prescribed assessments we expect subjectivity to prevail in the assessment for quality of administration and governance.
- Consultation with the employer: trustees do not currently have an obligation to consult with the employer (who ultimately supports the scheme) on the value for members assessment or its conclusions. A formal requirement to do so would help employers to assess the value for their spend, and would encourage greater collaboration between trustees and employers on DC issues, including value for members and consolidation.
- Hybrid schemes with DC assets less than £100m: re-defining the threshold as 'DC assets' as opposed to 'all assets in the Trust' would encourage hybrid schemes with smaller DC sections to consider whether members would be better off in a larger DC arrangement. It is not uncommon to see DB focused activities taking precedence in hybrid schemes, and some DC activities, that could lead to better value for members, being placed on hold. Given limited resources, time and budget there exists a trade-off between DB and DC activities in many hybrid schemes.
- Visibility of alternatives: whilst there is a healthy master trust and group personal pension market, trustees and employers struggle to compare these easily because few, if any, provide clear information in the public domain on typical charges, regularly updated risk-adjusted investment performance (in an easy-to-find place), or examples of "what to expect". This makes seeking a new arrangement an often complex and bespoke exercise. It is hard to "shop around" or browse easily. Any drive for consistency and comparability would be helpful.
- Pensions dashboards: prioritising the launch and success of dashboards will, in our view, help members to consolidate their DC funds more easily themselves.
- Mandatory consolidation: whilst our preference would be for scheme-led consolidation, government could mandate consolidation if certain criteria are consistently not met. These criteria would set minimum expectations for a DC scheme and its members and would need to be standardised and formalised.

3. *How can government incentivise schemes with assets of between £100m-£5bn to consolidate?*

We do not consider it appropriate for government to incentivise schemes to consolidate where they are well governed and consistently demonstrate that they deliver value for members. Such schemes would be expected to consolidate where they identify a need to do so.

However, supporting schemes in their (existing) value for members assessments by driving for the availability of public information on alternative options would be welcomed by governance bodies, to enable them to benchmark their assessment against the market.

4. *Assuming a scheme wishes to consolidate, how significant are the barriers identified above?*

We recognise each of barriers identified by government and comment on these further below. However our expectation is that the cost of wind up and unwillingness of potential receiving schemes to accept 'low value DC pot' members are likely to be the most significant where smaller schemes are concerned.

<u>Member-borne costs:</u> Due to the weight placed on member borne costs and charges in value for member assessments, it is more likely than not that a bulk transfer assessment would conclude that a transfer to a larger scheme would not be in the best interests of members if costs are higher (due to the cost of transfer and / or higher ongoing charges). As employers generally expect consolidation to lead to reduced operational and ongoing costs for them, few tend to consider compensatory measures that could enable a transfer.

<u>Costs of transfer</u>: In the absence of any surplus funds in the scheme, wind-up costs would need to be met in full by the employer, and so change will be dependent on the strength of the arguments given by the trustees for consolidation. We agree that wind up costs could be prohibitive for smaller schemes who may maintain the status quo as a result. The additional risk is where schemes look to wind up without seeking proper advice.

<u>Low value DC pot members</u>: whilst there is less ability for smaller schemes to obtain competitive terms our expectation is that NEST could be a viable option as a receiving scheme.

Are there others [barriers]? How do barriers vary for medium-larger schemes?

The following issues are common across the schemes our members work with (note that these are more commonly found in hybrid schemes).

- Pre April 2006 tax protections that could be lost on transfer: where members have DB and DC within the same Trust, protected pension ages or protected pension commencement lump sums can be lost on the transferring DC savings without winding up the scheme containing the remaining DB benefits.
- DC savings with Guaranteed Minimum Pension underpins or reference scheme test benefits: these underpins cannot be replicated in a DC master trust.
- DC savings that carry discretions or rights: as an example, the ability for members to take part of their DC savings into the DB section of the scheme to use against their tax-free cash allowance.
- A further barrier may exist if the scheme considers that consolidation is likely to trigger a wider review by the employer of the contributions it pays on behalf of members and any additional or unusual benefits members may be entitled to as a member of the scheme (e.g. a DB style ill health benefit). A levelling down of the contributions or removal of additional benefits due to the transfer itself may lead the scheme to conclude that a transfer would now not be in the best interests of members.

- In seeking to consolidate and wind-up, some trustees (both lay trustees and professional trustees) may be conflicted if they enjoy and value being a trustee for personal reasons. They may be hesitant to give up their role despite increasing governance burdens.
- For medium-sized and larger schemes, where these are hybrid schemes we see an even greater risk that DC consolidation projects could go on hold or be delayed where DB priorities take over. For example, GMP equalisation, risk transfer projects, etc.

Perhaps most crucially, it is worth reiterating that a change in vehicle is a decision that sits with the employer as opposed to the trustees, and the employer will ultimately be responsible for the cost of change. It can be very difficult for trustees of DC schemes where the employer is unforthcoming on agreeing budgets (even including existing projects required by regulations). Trustees are required to carry out certain projects, seek certain regulated advice, etc, whereas the employer is not, and trustee boards have very little freedom to do what is best for the scheme in these cases. Some additional regulatory requirements on employers might help here.

How can the government, regulators and industry remove these barriers?

- Changing regulations such that members do not lose their protections on transfer (e.g. protected pension ages, protected pension commencement lump sums).
- Establish a streamlined, low cost, process for schemes with low value pots to consolidate in NEST.
- Passing regulations such that changes to the DC contribution and benefit structure should not be made by employers/schemes purely as a result of the transfer. We recognise challenges on this point, but constructive steps could include a requirement to maintain the existing contribution structure for a period (e.g. 12 months) post-transfer.

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

Please see our response to Question 3.

We would expect to see potential solutions to the issue through the work that the Small Pots Co-ordination Group is undertaking (future long term consolidation model). We would also expect schemes to obtain better commercial terms for members that have smaller pots through NEST.

5. *How can we mitigate any risks associated with scheme consolidation?*

- Reasonable timescales and effective project management: Schemes should not be rushed to consolidate by setting an expected timescale by which the consolidation should be completed. This risks errors being introduced into the process that may not be able to be reversed at a later date.
- Capacity crunch: There could be a capacity crunch with master trusts struggling to meet a spike in demand. Medium and larger schemes are more likely to go to tender for a master trust and so any government incentives may better support the market if phased in over a period of time.

- Requirements for proper advice: Schemes should be encouraged to take appropriate advice, even if considering transferring to a master trust. The master trust authorisation regime should not set expectations that advice is not required and that better value for members is a given.
- Consolidation of larger schemes – assets up to £5bn: It's unclear whether master trusts are captured. In order to encourage competition and innovation we would expect commercial master trusts to be carved out and for new commercial master trust to be supported in entering the market.

6. *What other international good practice exists?*

The Australian superannuation schemes are the most obvious international example of consolidation, and both the benefits and risks associated with such arrangements.

7. *How important is scheme consolidation in driving better member outcomes?*

We believe that consolidation is more important for smaller schemes than medium to large schemes in driving better member outcomes.

That said, we do not have any evidence to suggest that there is a correlation between scheme consolidation and driving better member outcomes. The key drivers of outcomes are participation, contribution rates, and engagement. If a member has inadequate savings rates (or opts out), and is not engaged, then being in a larger scheme will not help with this per se.

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

We believe that it would be helpful to introduce more prescribed value for members assessment frameworks for all schemes with guidance on weightings for each area to be assessed. Our suggestions in this respect were detailed in our response to the DWP's consultation "Driving value for money in pensions (CP20/9)".

Government should however be cautious of setting "hard rules" around net investment returns below a certain threshold triggering consolidation. This is a minefield - what time period is reasonable? How are the risk levels of different strategies accounted for? What is the benchmark comparator? What cohort of members (at what point of the lifestyle period) do schemes look at? This will need careful consideration.

8. *How can government, regulators and industry incentivise scheme consolidation?*

Please see our response to Question 3.

9. *Is there anything else, not covered in the other questions, that the government should consider*

No further comments.

We would be happy to discuss our answers further if that is helpful. In that event, please contact Tess Page, Chair of our DC Committee, on 07557 031198 or at tessa.page@mercer.com.

Produced by: **Association of Consulting Actuaries (ACA)**

First Floor (129) · 40 Gracechurch Street · London · EC3V 0BT

Tel: +44 (0)20 3102 6761 · Email: acahelp@aca.org.uk · Web: www.aca.org.uk

29 July 2021