HYMANS ROBERTSON

Future of the defined contribution pension market

Hymans Robertson's response to the call for evidence on barriers to greater scheme consolidation in the UK DC pension market

July 2021

Contents

Our response to the DWP’s call for evidence	Page
Introduction	1
Our details	1
Executive summary	2
Responses to specific questions	6
Appendix - Reference materials	10

Introduction

Hymans Robertson provides independent pensions, investments, benefits & risk consulting services, as well as data & tech solutions, to employers, trustees and financial services institutions.

We are pleased to accept the opportunity to respond to the Department for Work and Pensions' (DWP's) call for evidence on barriers to greater scheme consolidation in the UK defined contribution pension market. In particular, we welcome the approach taken to seek evidence, and would welcome further opportunities to engage with the DWP to elaborate further on the areas we have highlighted and potential measures to address.

Our details

Your name:
Lee Hollingworth

Organisation (if applicable):
Hymans Robertson LLP

Job title (if applicable):
Partner

Postal address:
One London Wall
London
EC2Y 5EA

Telephone:
0207 082 6324 / 07827850707

Email:
Lee.Hollingworth@hymans.co.uk

What category best describes you or your organisation?
Professional Advisors

Executive summary

We are supportive of further consolidation in the UK's workplace pension provision. However, we believe that taking consolidation further and faster than already in train would be counter-productive by reducing competition and innovation. We suggest that more is done to alleviate the technical barriers to consolidation.

Good progress is already being made in introducing illiquid assets into DC investments – although investing in the UK economy must compete on merit. We do not expect enabling performance related fees within the charge cap to be attractive due to the fiduciary issues it creates for both Trustees and providers.

Too far

Immaturity of the provider market.

DC assets are still growing since it took over from DB as the main source of pension provision in the UK and auto-enrolment was introduced.

The master trust providers are all in the process of acquiring scale post-authorisation. The impact of phase one of the consolidation process will take some time to work itself through with the hope and expectation that what will result is a functioning competitive environment between c. 20 providers each managing assets in excess of £10bn. Now is not the time to introduce a further phase of consolidation.

The main master trust providers have also yet to reach a point where a superior product solution can be demonstrated than that available from large single trust schemes or indeed smaller master trusts. Today, through whatever lens viewed: value, member charges, digital UX, investment sophistication, etc… many large single employer schemes provide a superior all rounded offering to the consumer. In addition, we are in favour of retaining a high-level of employer engagement in their staff pension schemes.

The risk of disenfranchising the sponsoring employer

The employer has always played a central role in the provision of pension benefits to their staff and never more so than through auto-enrolment. Surveys have shown that many employees see their employer as a trusted source of financial information against a backdrop of a generally low level of financial education. In addition, employers and member-nominated trustees will have first-hand knowledge of each member which, for example, can ensure that the investment options are a good fit while bereavements are handled sensitively.

There is a risk that with widespread outsourcing through master trusts and minimum legal contribution requirements that pensions simply become a hygiene factor within the employee benefits package and that employers become less involved in the retirement outcomes of their workforce. Given the widespread individual apathy that exists today (and is likely to remain) among employees this is a worrying trend. What can be done to combat this?

- A requirement for all sponsoring employers of qualifying schemes to review VfM and outcomes (basis to be prescribed) periodically (e.g. every 3 to 5-years), and take action if a "better" deal is available.
- For employer sections of master trusts over a certain size, e.g. £100million a requirement to engage in a joint governance model with the provider to retain an interest and some responsibility. Also, employers always retain "ownership" of assets (active, deferred and pensioner) to provide increased leverage and avoid providers giving worse deals to sections of membership (e.g. deferred).

We think that key to any regulatory change, is to close the current gap between the 'haves' and 'have nots' in the industry. I.e. larger schemes or those with greater resources that typically benefit from lower charges and greater access to innovation, relative to smaller schemes who often lack these benefits.

Vertical integration represents a threat to a functioning provider market

Vertical integration, wherein the Scheme Funder of a Master Trust is also an asset manager, has resulted in investment defaults that are usually exclusively managed by the Funder. This gives rise to a number of concerns including: over-reliance on one manager with hurdles to changing under-performing funds, potentially a narrow range of investment solutions and is not openly competitive (because of the significant cost advantages vertical integration gives). The Trustees often then find themselves constrained on the use of external managers due to the addition of platform charges and do not then have the tools at their disposal to design a best in class default option. Such additional charges are typically waived for internal funds which potentially acts against effective competition.

Some form of intervention is therefore necessary to ensure the trustees feel empowered to always have a mandate to pursue a best in class fund strategy. For example, a maximum permitted percentage invested in funds associated with the Funder. The challenge does not rest solely with investment implementation. We also believe there are similar implications for administration services.

Competition and innovation

The data in the consultation shows the charges for UK workplace pensions ranks amongst the lowest in the world, but there is a lack of real competition and innovation. It should not be assumed that low charges translate to better outcomes for members.

We have long seen in the corporate pensions market that innovation starts with smaller providers and fund managers before spreading to the major players. Auto-enrolment is a case in point, where technology-driven new entrants have disrupted the market to the benefit of consumers. High Street banking has shown how difficult it is for challenger banks to break the hold of the major banks. We have a concern that if taken too far, consolidation will lead to an oligopoly of too large to fail master trusts which are unresponsive to members' and employers' needs and a certain degree of price fixing with limited competition.

It is essential to focus energy on creating real competition in the market and ensure barriers to entry are not prohibitive.

Cost

There has long been an obsession on cost in the industry aggravated by the introduction of the charge cap. The current DWP proposal for a standard universal charge system could worsen this by disrupting different competing commercial models.

We are concerned that the value for members metrics being implemented within the regulations currently before parliament will undermine progress towards a wider perspective of what members value and delivers good outcomes. At the same time, the biggest single driver of good outcomes, the level of contributions, has been ignored.

We are also seeing that the benefits of consolidation are weighted towards larger employers. While the charges for investment management do reduce (by a fraction of a percent) with scale, the benefit of these savings is lost on smaller employers where the provider's fixed administration costs per employer and per member are a materially larger proportion of the overall % charges. Conversely, any move towards a level charging structure would stop consolidation in its tracks, because larger employers would not wish to subsidise smaller employers. As a result, what we expect will happen is a move of the current non-equitable charging structures that favour large single employer schemes to Master Trusts which will not solve wider issues regarding charging across our industry.

There needs to be a change of behaviour across all stakeholders with a greater focus on value and good member outcomes.

Too fast

Measures to reduce the friction of consolidation

The process of moving either between an employer trust and a master trust and even between master trust themselves is a considerable undertaking for the sponsoring employer as well as their advisers and the providers. How might this be mitigated?

- Make legislative changes to fix barriers to transfer. e.g. linkages for AVCs (e.g. tax-free cash), potential loss of protections (for instance the protection follows the member rather than being linked to a scheme), DB underpins (e.g. reference scheme test), GMP underpins and equalisation, etc…
- Ensure ceding trustees can feel confident that any transfer to an authorised master trust regardless of ongoing member charges and transition costs can be made without future risk of litigation. We expect that some trustees may seek indemnities from the employer in certain instances.
- Reduce costs associated with asset transition (e.g. stamp duty exemption, etc.)
- Make it easier for Trustees to access DC assets trapped with legacy run-off providers;
- Find a way for members to receive fair value in lieu of With Profits guarantees and as yet undistributed investment returns;
- Introduce over-riding legislation enabling amendments to scheme rules which prevent transfers without member consent or requirements for comparability of benefits;
- Give Trustees of exporting schemes more flexibility on where transferring members are invested by simplifying the charge cap regulations so that transfers to master trusts without member consent do not create default arrangements subject to the cap and its reporting requirements
- Wider financial engagement and workforce management through an integrated provider/ sponsoring employer/State approach.

Improving the overall level of scheme governance

We are already seeing large well-governed schemes moving into master trusts as employers seek to reduce the overheads of pension provision. This trend is likely to continue as employers seek to recover from the Covid pandemic.

Inevitably, transfers of larger employers, who are more commercially attractive to proprietary master trust providers, are taking up resources at the expense of smaller schemes where the standard of governance is more likely to be a concern. It’s important that consolidation doesn’t lead to a reduction in the number of master trusts who see small to medium sized employers as a viable target market.

We also believe that the overall impact on member outcomes could be lost in translation if there continues to be too much emphasis on price. The negative effects of moving members from a bespoke lifestyle strategy with 100% growth assets in the early years, to a Master Trust’s generic default with typically less than 100% in growth assets is likely to outstrip any modest benefits in terms of reduced charges. For example, a 10% reduction in the allocation to growth assets in favour of low risker investments in the early years could be expected to reduce a 25 year old member’s retirement outcome by around 10%, whereas a 0.1% p.a.reduction in charges on moving to a master trust is likely to improve their retirement outcome by around only 3%.

Investing in illiquid assets

We have a fundamental view that there are attractive investment opportunities in private markets that can enhance members' long-term outcomes and improve their engagement in long-term saving. In particular, we believe that private markets offer more direct opportunities to invest in ventures that will support the world's transition to a lower carbon and socially just world.

The DC industry is very much in its infancy in terms of incorporating private markets assets. However, we are already seeing innovative solutions to this which encompass both private equity and credit assets, and operate within the existing framework of daily dealing and valuations, and charge cap.

By driving regulation around private markets assets too soon, we could lose a golden opportunity to learn from innovation, and ultimately stifle the ability to improve individual member outcomes over the longer term.

We believe that emphasis should instead be placed on improving levels of transparency of costs and charges, and not over-regulating the frameworks for their assessments. For example, trustees already need to satisfy that changes to the investment approach are in the interests of their members.

By smoothing performance fees, members will pay a generally higher fee level at times when the fund is underperforming, and this is something we don't feel is consistent with delivering good outcomes for all members. We note that the smoothing of performance fees is, rightly, optional in the regulations coming into force from October this year."

The current proposals for Long Term Asset Funds do not appear to address the significant practical challenges that exist for DC schemes to invest in private markets assets. Indeed, the proposals appear to introduce additional governance burden and risk and we are unconvinced that they will offer a sufficient competitive advantage for trustees to select relative to other opportunities.

Ultimately, we think there are better ways to access illiquid assets for DC and prefer to allow time for the market to innovate towards best in class solutions.

Responses to specific questions

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

We agree with the principles behind consolidation, and that increased scale can lead to greater cost efficiency for DC savers and scope to access illiquid assets. We are concerned that consolidation, if pushed too quickly, could lead to a relatively uncompetitive market and not deliver the anticipated benefits to DC savers. For example, research from Corporate Advisor shows that there are 27 DC providers responsible for around £495bn in members' assets. However, the largest 4 providers are responsible for around 65% of members' assets. This demonstrates that the current DC provider market is not wholly competitive.

By accelerating the pace of consolidation, we risk perpetuating the current lack of competition in the market, and ultimately harm members' longer-term outcomes. In particular, this approach creates barriers to entry for which could stifle innovation in the market. In addition, there is a risk that assets managed by a few larger providers will lead to a 'one-size-fits-all' approach for members, where the key to delivering good outcomes is to recognise their varying and diverse needs.

Question 2: What impact will the new value for members assessment have on consolidation of schemes under £100m? 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? Beyond the value for money assessment, could government, regulators and industry accelerate the pace of consolidation for schemes under £100m?

We think that many schemes under £100m in size will find that they lack the resources to effectively adopt the new value for members assessment and this supports the desired policy outcome to accelerate the pace of consolidation for schemes under £100m. We believe guidance should be offered to help trustees of single-trust arrangements consider and address the key challenges associated with a transition to a Master Trust arrangement. The Appendix sets out the findings from an industry-wide DC Governance Group consisting of pensions consulting firms and pension practices at law firms, which we support.

One of the key challenges with any transition of a DC arrangement is transferring the administration services. Existing provision often relies heavily on internal resource given the link to HR and payroll services. Our conversations with smaller schemes have identified that the inability to resource a transition is a specific barrier to moving to Master Trust, even where there is scope to enhance value for members. We think this challenge can be supported through the provision of practical guidance, to improve confidence, and providing assistance (financial or otherwise) to smaller employers to help them ease the operational burden of facilitating a transition.

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

We need to recognise that schemes between £100m and £5bn in size are often well resourced and have greater access to suppliers and advisors to improve member outcomes. A key challenge will be to demonstrate that Master Trusts can deliver better outcomes for individual members relative to schemes in this group. Also, would this policy shift increase the number of members saving sufficiently for retirement? We are not convinced at this stage.

We believe that the most important incentive is to promote a competitive Master Trust market. Through competition, Master Trusts will innovate towards market leading solutions for members, delivered at optimal cost.

We think the Master Trust market could grow by around £50bn each year over the next decade. However, we lack confidence in the ability for this market to deliver the additional capacity need to address a significant acceleration in consolidation without compromising on quality or risk management standards. Ultimately, too quick a transition to Master Trusts could be harmful to individual member outcomes.

Question 4: Assuming a scheme wishes to consolidate, how significant are the barriers identified above? Are there others? How do barriers vary for medium-larger schemes?

The barriers are significant for smaller schemes, for the reasons noted above. Although medium to larger schemes are less likely to face challenges in terms of resourcing a transition, the main challenge will be demonstrating that moving to a Master Trust will lead to improvements in individual member outcomes. Ultimately, we believe this is a function of an uncompetitive DC Master Trust market.

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

There are a number of steps that could be taken to improve competition in the DC Master Trust market, and we feel it may be beneficial to issue a further consultation focussing solely on this area.

We have outlined some initial suggestions below:

Emphasis for larger providers to demonstrate how they are improving member outcomes

Our analysis suggests that the Master Trust market could grow to around £700bn by 2030 and consist of between 15 and 20 providers with around £40bn of assets (on average). Those exceeding that level of assets could be required to demonstrate how they are innovating to deliver better outcomes for members. Ultimately, those failing to deliver for members could be forced to break up to improve competition.

Challenge conflicts of interest for existing provider models

Whilst providers funded by an asset managers, insurers and consultancies arguably have access to a wealth of resources and products that could drive better outcomes for members, the potential for conflicts is heightened. We believe a review of these models is warranted to ensure that conflicts are being adequately addressed before the DC market reaches a massive scale. One potential solution is to require fully independent trustee boards, and require those boards to whistle blow where they identify significant practices from the funder that they believe is not consistent with delivering good outcomes for members.

We also believe that the Pensions Regulator could be more closely involved in the ongoing supervision of Master Trusts, recognising that there is currently a range in terms of the effectiveness of different models. The Pensions Regulator would benefit from greater resource to deliver this.

Ease barriers to innovation for smaller Master Trusts

Many of the smaller Master Trusts have the ability to select their partners from the wider market and arguably have greater scope to drive competition in the market and select innovative technological and investment solutions. However, cost is a barrier given their scale.

We believe there may be merit in establishing a framework for employers to assess potential Master Trust providers. In particular, we believe that cost should be removed from the consideration unless there is more than one provider able to deliver the employer's wider requirements, where this would be used only to decide between otherwise comparable offerings.

Question 5: How can we mitigate any risks associated with scheme consolidation?

As referenced earlier, we support the guidance proposed by the industry-wide DC Governance group. We would advocate this being translated into formal guidance from the Pensions Regulator to assist trustees in this process.

Question 6: What other international good practice exists?

Reference is often made to the Australian model of pension provision. That model requires individuals to select a "super fund" and then consider a choice of defaults rather than be defaulted into an arrangement specified by the employer. We think the former can lead to better levels of engagement for individual members, and assist with competition in the market since this will be driven by consumer demands rather than resource constraints from individual employers.

Moving fully to that model would be a radical change for the UK occupational pensions market and maybe prohibitively expensive, however, we do think that lessons can be learned.

In particular, increasing the scope for individuals to select their own pension arrangement rather than be defaulted into the employer's arrangement may be beneficial. This could be achieved by revisiting the current auto-enrolment legislation, and easing the frameworks for individuals to select alternative pension arrangements as qualifying schemes. Value for member assessments could be used as a helpful tool to aid individual members in selecting different pension options, provided this is supported by regulation to in this area to aid comparison.

We note that there could be potential challenges from a payroll perspective, particularly for smaller employers, but this should be balanced with a desire to improve engagement.

This is also not to compromise on the important role employers have in driving engagement with individual savers. The main challenge that would be addressed is that providers, as they continue to grow, risk becoming broad churches that do not adequately cater for the needs of a diverse range of savers. The Australian model supports greater levels of choice in terms of investment solution too, which is an area that could be explored further with the aim of delivering an improved experience for individual members.

By offering additional choice to individuals, we can temper the requirement for employers to put forward a qualifying scheme for auto-enrolment purposes, with the potential lack of choice and innovation this could present in time.

Question 7: How important is scheme consolidation in driving better member outcomes?

As noted earlier, we believe in the principle of consolidation and opportunity to improve member outcomes. However, we do believe there are limitations. The approach must have a bottom-up emphasis, so we can raise the bar for those most likely to see the benefits from a Master Trust arrangement.

We are also concerned that barriers to entry for new players and disrupters could stifle innovation and lead to more one-size-fits-all approaches, which will ultimately fail to deliver the best possible outcomes for individual members.

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 agree that it's crucial that low charges and costs are not viewed as the key driver of improving member outcomes. Governance quality, competition, tailoring to individual member needs and quality of investment options all have a role to play in delivering an improved overall experience for members.

Rather than focus on overall net returns, we think emphasis should be placed on members' retirement outcomes which ought to be the driver for any strategic investment decisions. In principle, regulation could be introduced to enforce a "comply or explain" requirement for decision makers to demonstrate why they believe by not increasing charges they are not missing opportunities to improve outcomes on a net basis. Indeed, we've previously advocated the introduction of a charge floor to ensure that schemes take advantage of the opportunities that exist to improve individual member outcomes net of charges.

We think the key is to support greater levels of competition in the market rather than overregulate individual schemes. In a competitive market, there would be little need for the current charge cap, and this would remove the current emphasis on absolute charges across the industry in our view.

Question 8: How can government, regulators and industry incentivise scheme consolidation?

As noted previously, we believe the emphasis should be placed on smaller schemes where the positive impact of consolidation in terms of improving individual member outcomes is likely to be most significant.

We have commented on potential ways to support consolidation earlier in our response.

Question 9: Is there anything else, not covered in the other questions, that the government should consider?

We believe that the current auto-enrolment contribution levels are not sufficient to deliver good long-term outcomes for many individual members. We suggest the government considers reviewing the current auto-enrolment legislation to make enhancements. We suggest further consideration is given to increasing minimum contribution levels, and increasing scope for individuals to select their own pension provider.

Appendix - Reference materials

The following document, prepared by an industry-wide DC governance group, comprising of pensions consultants and representatives from pension practices at law firms, focusses on the challenges associated with transitioning from single occupational trust schemes to Master Trust arrangements:

Challenges in transitioning from s