PASA Consultation response

Pension and Investment Review: Unlocking the UK Pensions Market for Growth

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PASA

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Acknowledgments

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David Fairs (DC Board Sponsor)	PASA Board Director
Jessica Rigby (DC Chair)	
Andy Cheseldine	Capital Cranfield
Catalina Esler	Evolve
David French	Heywood
David Porter	
Ferdy Lovett	Sackers
Gary Graham	
Gillian Bell	Hymans Robertson
Glen Bown	Scottish Widows
Helen Ball	Sackers
Helen Hurst	Hymans Robertson
John Simmonds	CEM Benchmarking
Jonathan Sharp	Baker McKenzie
Lesley Carline	KGC Associates
Michael Ambery	Standard Life
Peter Glancy	Lloyds
Sharon Cairney	Fenner Group
Shri Krishnansen	WealthOS
Stephen Coates	Mercer
Tony Brown	Muse Advisory
Gareth Stears (IPC co-Chair)	Aries
Ross Wilson (IPC co-Chair)	Gallagher
Grant England	Mercer
Rosie Kwok	LCP
Uche Egenti	First Actuarial

About PASA

The Pensions Administration Standards Association (PASA) was created to provide an independent infrastructure to set, develop, guide and assess administration standards.

PASA acts as a focal point and engages with industry and government to create protocols for understanding good administration - but also appreciates there's no one size fits all. PASA develops evidential Accreditation practices allowing benchmarking across and between the industry regardless of how the administration is being delivered.

As well as raising the profile of pension administration generally, PASA focuses on three core activities:

1. **Defining good standards of pensions administration relevant to all providers, whether in-house, third party or insurers**
2. **Publishing Guidance to support those standards**
3. **Being an independent Accreditation body, assessing the achievement of good standards by schemes**

There's no organisation providing such services across schemes, yet there's a demand for evidence of service quality from scheme trustees, sponsors, administrators, insurers, savers and regulators.

1 Summary

The joint DWP and Treasury proposal will impact UK pension schemes in many respects, but the move towards much larger schemes is the greatest likely change. Consolidation is ultimately an administrative process, and consolidating at scale requires a level of systemisation and automation currently not present in the pensions industry. A drive towards a consolidated market will place a heavy burden on an industry already under strain from legislative and regulatory requirements. While the ultimate goal may be to drive efficiency and lower costs, in the short term, the opposite is likely to be the case.

Our response only covers those questions which directly impact scheme administration. However, we acknowledge many of the proposed changes and the questions indirectly affect administrative matters. For example, the number, constitution and diversity of default investments will inevitably have administrative implications in how schemes communicate with savers and determine the functionality and transactional capabilities offered. Similarly, changes to consent rules on transfer will impact existing scheme processes currently geared towards affirmatory, consent-driven methods. In particular, safeguarding policies on transfer may fall, at least partly, to new administrative processes requiring a scheme to assess the suitability of a receiving scheme before a transfer is made.

Passing the 'scale test'

In addition to our responses, we've also set out our observations on scale and what it means in practice. The purpose of scale is to create the opportunity to compete for investment opportunities and to create value, but it's important to determine how this scale is built and accredited.

At present, there are three layers of investment:

1. **Arrangement Level** – the layer the saver sees. This could be a Target Date Fund or a Lifestyling Fund
2. **Building Blocks** – a small number of funds with different levels of risk/reward through which savers are phased to achieve the Target Date or Lifestyling outcome
3. **Underlying Funds** - many of the building blocks above are fund-of-funds, and so the third layer is the underlying funds, managed by internal or external asset managers into which many organisations invest

To an extent, the question of which level is best to set an asset threshold or a cap on the number of funds is a red herring. The real question is whether a scheme operator permitted to participate in the market as an AE operator, has an asset pool which can invest in the ways deemed to be in the best interests of members (saver outcomes and any broader societal and economic benefits Government and Regulators determine to be necessary).

These could include:

- Minimum size to at least one of the asset pools operated by the qualifying provider. NB: For innovation in fund development – smaller additional asset pools should be permitted to develop and launch new concepts
- Demonstrate the ability to use the scale of the asset pool to drive a good deal on price from both Asset Managers and Private Equity Sector
- Demonstrate ability to deploy £5bn (example) in illiquid/productive assets – at points in the cycle where these represent saver upside

The Government may choose to build on the Master Trust Accreditation framework for an approach to consolidation. It would be for each pension scheme operator to set out a business plan, operating model, customer proposition, etc which satisfied the tests being set out, avoiding the need to design a complicated technical set of rules, which may be full of unintended consequences.

2 Consultation questions & answers

Question 5: Do you think there should be targets for (i) achieving a reduction in default fund numbers down to a single fund and, (ii) setting incremental minimum AUM?

Yes. The proposed new default fund requirements need to be introduced carefully to avoid causing ‘disorderly' changes within the market. If no centralised management controls their introduction, it would be unclear which assets (at scale) needed to move, where they would move to, and when. This uncertainty could undermine the policy objective of achieving speedy consolidation. Parties may wish to avoid being a 'first mover' and wait until others have first been through the process. It would also have implications for pensions administration as the movement of funds is not just a financial transaction – it has significant consequences for saver records (including the upcoming pensions dashboards and small pots consolidations), saver communications and customer trust/understanding.

In the absence of any structure being put in place around potentially significant movements of assets, it would be challenging to plan for and execute other important projects, not only those directly related to investment changes. We would support an approach outlining in advance how the different stakeholders are expected to meet the new requirements. Targets would be one way to achieve this, although they would need to be sufficiently flexible to accommodate unexpected events such as corporate restructures, economic conditions (e.g. the gating of investments during Covid). We also need to consider the practical constraints, particularly administrative capabilities to absorb a large number of investment transfers all within a short window of time.

Question 6: Are there any potential barriers/challenges that should be considered in reaching a minimum size of AUM at default fund level before a future date, such as 2030?

There are potential barriers/challenges in a number of areas.

Resource, costs and capacity – the 2030 timeframe could be challenging to achieve the targets mentioned in Question 5. This would require a significant amount of resources to be spent on administration in a short period, during a time when the Government is asking trustees and employers to focus on providing 'value'. The capacity crunch within administration has been well documented, and despite steps taken to alleviate it, it’s still a significant consideration. Greater training and upfront 'investment' in such resources would be needed in advance to ensure the capacity to deal with the work the movement of assets would involve.

Legislative – there may need to be changes to the master trust transfer legislation which doesn’t currently deal well with non-emergency exits from the market. Equally, the pensions consultation regulations will create additional governance/administrative challenges for employers where assets are being moved from/between different 'governance wrappers' (GPP to GPP, GPP to master trust, master trust to master trust) without appropriate exemptions where the benefit position for savers in terms of contributions will remain the same.

Complex benefit structures – some DC arrangements have complex legacy benefit structures presenting barriers to consolidation. They're difficult to 'unwind' when assets are consolidated or can present issues for trustees concluding a transfer is in the interests of savers. These can be with profits DC, DC structures linked to defined benefit outcomes in a 'best of both' sense (e.g. DC with a DB underpin or vice versa) or where the DC benefit element is a 'stepping stone' to defined benefit accrual. These dynamic benefit promises are administratively complex and are difficult to replicate in a receiving arrangement such as a DC master trust. Thought should be given as to any legislative easements which could be brought forward in this area.

Behavioural – given the significant work involved in a project to consolidate DC savings – whether from a single trust into another single trust/master trust or between master trusts themselves – stakeholders may have concerns about being 'first movers' transitioning savers into arrangements which could potentially be consolidated in due course. Therefore, there may be reticence to commit administrative resources and costs to these projects.

Question 7: Given the above examples, what exclusions, if any, from a required minimum size of AUM at default fund level and/or the maximum number of default funds requirement should government consider?

As noted in our response to Question 6, there may be challenges to consolidation for schemes whose structure involves interconnectivity between DC and DB elements. Forcing consolidation in these circumstances could result in material challenges in replicating the DB/DC interaction across two different pension arrangements and this may fundamentally disrupt the original benefit design for the relevant memberships. Consideration should be given to exclusions for these schemes unless and until there are legislative solutions to dealing with the complexities of some of these benefits.

The analysis carried out by DWP in 2023 on the market segments of master trusts concluded part of the market comprised 'non-commercial master trusts'. While subject to higher levels of regulatory oversight, these schemes aren't necessarily seeking to increase scale to gain a higher market share. Instead they may be seeking to maintain the provision of a bespoke benefit design for their memberships. Consideration should be given to exclusions or easements for these types of schemes if and to the extent consolidation may disturb the original benefit design intended for the relevant memberships.

Question 8: With regards to the proposals in this chapter, we anticipate the need for mechanisms to encourage innovation and competition, and for safeguards to protect against systemic risk. Are there other key risks that we need to consider? How do we mitigate against them?

There are other risks relating to the timing of these proposals and their implications for other important projects, such as the Value for Money policy, pension dashboards, and small pots consolidation. It will be challenging to encourage stakeholders to follow those existing projects through to completion unless there's a clear roadmap for providers, employers and trustees, and it will be imperative to communicate these plans to savers.

Innovation could come from existing participants or new market entrants. Existing participants which pass the scale test more generally should be allowed to operate smaller funds for innovation in fund development. This may then, in the future, translate into changes to the primary fund to benefit the wider membership.

New market entrants should have the same opportunity to set out a business plan to demonstrate scale and be given 10 years in their business plan to achieve scale. Competition is maintained, but only those with the appropriate resources and capabilities come forward.

Question 11: How would moving to a single price for the same default impact positively or negatively on employers, members and providers?

Moving from 'scheme underwriting' to a single price would introduce a significant cross-subsidy between workforces. The Government may wish to consult with regulators, including competition authorities and the business community (CBI, etc), to understand the broader impacts of forcing cross-subsidies into the system.

If cross-subsidies were to be extended this way, there could be an increase in scheme and saver switching activity, where employers or savers are unhappy with the price rise.

For schemes currently paying a higher price than the new single price, master trusts and GPPs can make the change without employer or saver consent, as contract terms would vary in favour of the saver. For those workforces where the price is increasing, master trusts can make the change without consent – but their clients (employers) may choose to seek an alternative provider. For contract based arrangements, the Contract Over-ride facility being introduced by the Government would be required to make such a change, but as with the clients of master trusts, clients (employers) may still choose to shop the market for a new provider following the change.

Overall – the administration impact is likely to be a significant rise in transfers in and transfers out at both an employer and saver level.

Example:

- **Employer A:** Pays workers well, has a generous level of pension contribution and workers stay with them for 10 years on average. The average pot size Is £20k.
- **Employer B:** Pays workers poorly, makes the lowest possible pension contribution, and workers only stay for 2 years on average. The average pot size Is £2k.
  - **Employer A** secures a scheme charge of 0.15%, meaning the average worker pays £30 per annum.
  - **Employer B** secures a scheme charge of 0.75%, meaning the average worker pays £15 per annum.

A pension provider's costs are in pounds and pence, which means the workforce of Employer A is already cross-subsidising the workforce of Employer B due to the charge cap. The cross-subsidy is only £15 per saver. However, if we moved to a single price at the halfway point of 0.45%, then workers within Employer A would now be paying £90, while the workers within Employer B would now only be paying £9. This increases the cross-subsidy to £81 per saver. There may be a benefit to smaller employers without the resources or buying power to negotiate with the providers. However, those with the 'extra' buying power could end up on a worse deal.

Providers may feel compelled to opt out if the margins are insufficient, reducing choice in the market.

Question 18: Do you foresee any issues with regards to transferring savers from contract-based arrangements to either other contract-based arrangements or trust-based arrangements? If so, what issues?

At present, saver consent is required for each outbound transfer from the sending scheme and written consent in the form of a signed application for each inbound transfer into the receiving product (contract based). The Contract Override would be required to cover both the outbound and inbound elements. HMRC would also need to be satisfied with the documentation of the inbound process.

The sending scheme now operates under the FCA's new Consumer Duty, but it also has other existing duties to ensure the destination scheme isn't a scam. The provider, under its Consumer Duty, will likely need to ensure the receiving scheme isn't a scam, **but** also represents good value for money. This could involve checking its RAG status under the new VFM Framework to ensure the destination proposition is green. IGCs may be asked to offer a view on whether they would rate the destination product as 'green'.

There could be a minority of savers for whom the transfer from a legacy product to a modern product isn't in their best interests, for example where some have death benefits, guaranteed growth or guaranteed income benefits. Where this is the case, it may be appropriate to calculate a compensation payment which could either be paid directly to the saver (although this needs to be worked through for HMRC implications) or used to enhance the 'pot' transferring to the new scheme. There's precedent for this from Demutualisation 1999 – 2001 where compensation for loss of With Profits membership rights was calculated and compensation was paid.

For these product transfers to make sense for everyone, the providers need to be able to close the computer systems on which they reside to avoid spending tens of millions on operating costs for only a handful of savers.

Many savers already find it challenging to track all their pensions. Moving it to a new location could make this situation worse for some. Ultimately, the provider will need to be better at keeping in touch. Although in time dashboards will help people track their pensions.

Question 21: What complications could arise if savers have the choice to opt-out of a transfer and remain in their current arrangement?

As set out in Question 18, operators will want to avoid a scenario where tens of millions of pounds must be spent maintaining obsolete computer systems for only a handful of savers.

All impacted savers need to be notified of any change in product or provider and any material change to product terms. They should be allowed to opt out of the transfer, but this should mean selecting an alternative destination product; they shouldn't have the option to stay where they currently are if the product is being decommissioned.

Individuals already have the right to instruct a transfer from either a master trust or a GPP to an alternative product of their choosing. They could instruct such a transfer from the 'sending' product provider before the bulk transfer or from the 'receiving' operator after the bulk transfer.

Question 25: How should the cost of the transfer be borne?

Savers and employers shouldn't have to pay transfer costs, assuming in most cases the transfer will take place without consent. Given the policy is investment-driven, it could be reasonable for the costs to be met by the receiving investment vehicle, which will, in theory, have future years to spread those costs across a large number of investors.

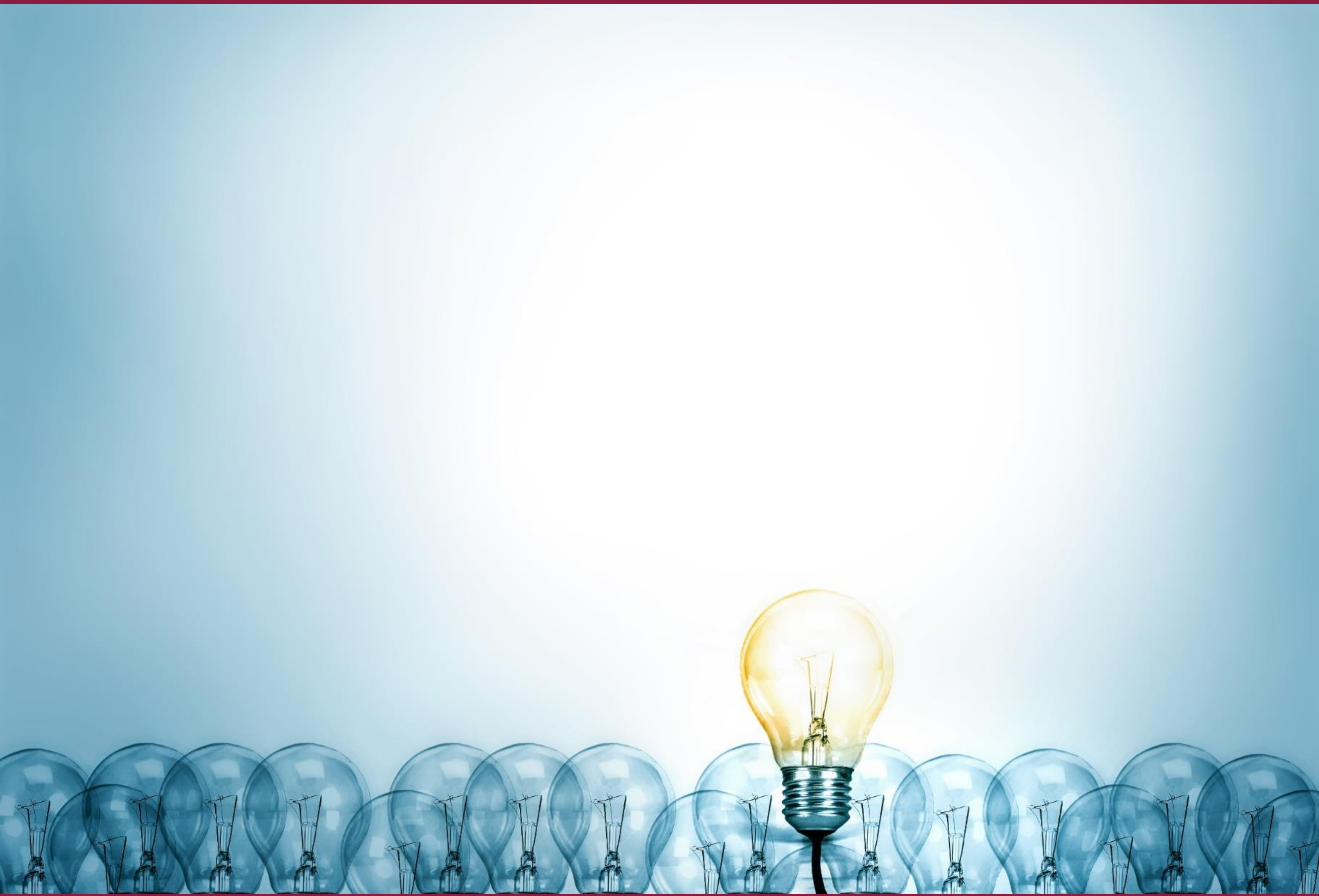
Product pricing (commercial master rusts and GPPs) includes onboarding costs, including establishing a new employer payment arrangement and saver onboarding, within the price. They also include off-boarding costs such as deaths, retirements, transfers out, bulk transfers out. The employer or a saver never bears the cost, and there's no reason for this to change.

Question 26: What costs do you expect to be involved in a contractual override/bulk transfer and what factors may influence the level of costs?

Costs involved in a transaction may include investment-related costs (transition) as well as any increased costs in the receiving arrangement (which may still be better 'value'). Other costs involved will be advisory: legal, investment consultancy, administration, and project management. The level of cost is likely to be influenced by the size of the transaction and the extent to which a similar exercise has been carried out before (the costs may reduce over time once a process can be more standardised).

As above, Product Pricing (Commercial master trusts and GPPs) includes onboarding costs, including establishing a new employer payment arrangement and saver onboarding, within the price. They also include off-boarding costs such as deaths, retirements, transfers out, bulk transfers out. The employer or a saver never bears the cost, and there's no reason for it to change.

There could be additional communications with impacted savers to advise them of the change, allowing them to opt out. Again, commercial master trusts and GPPs will have priced in ongoing communications with scheme participants, and there's no reason for any costs to apply to employers or savers.



Get in touch:

info@pasa-uk.com

www.pasa-uk.com

PASA is a Community Interest Company and our full name is Pensions Administration Standards Association CIC.
Company number: 6597097