Summary
- The government has proposed the creation of DC megafunds, greater than £25 billion in size, although consolidation was naturally occurring in the DC sector and there is still some confusion as to the practicalities of creating megafunds.
- The DB sector is also seeing consolidation into fewer, larger schemes, through the growth of superfunds, LGPS pooling and larger schemes being more likely to run-on, while smaller schemes wind up.
- Larger pension schemes are expected to have wider investment opportunities and greater economies of scale.
- There is concern that fewer schemes will result in a lack of industry innovation.
- The transition to fewer, larger schemes may mean more work for providers in the short term and a diversification of their offerings in the long term.
- There is scepticism as to how much benefit consolidation and fewer, larger schemes brings to the members.

Supersizing the pensions sector

As the drive towards DC consolidation ramps up, Laura Blows examines the consequences of the trend towards generating 'larger, but fewer' pension schemes on the industry

The controversial 2004 documentary, *Super Size Me,* recorded Morgan Spurlock's efforts to eat purely McDonald's food for a month. It had both an instant impact, such as the detrimental effects to his health during the experiment, and longer-term ramifications, by arguably contributing to the 'supersize' option fading away from fast-food outlets and the rise in 'healthier' convenience food venues.

Over 20 years on from the film, and the UK pensions industry is having its own controversial 'supersize me' moment, with political and regulatory pushes towards fewer, but larger in assets under management (AUM) size, pension schemes. To achieve this goal, consolidation throughout the sector is required. But is bigger always better, or, like the aftermath of the documentary, will it create knock-on events and unintended consequences years down the line?

DC proposals

The most recent area of focus for workplace pension sector consolidation has been the DC market. While The Pensions Regulator (TPR) has for many years highlighted how 'too many' small DC schemes are failing to provide value to members, and therefore recommended for those schemes to wind up/consolidate into a master trust, the government took this a step further last year.

"The government launched its Pensions Investment Review in November 2024, suggesting setting a minimum size for multi-employer scheme default arrangements ranging between £25 billion and £50 billion, by 2030. It wants to explore opportunities to transition to 'fewer, bigger, better-run schemes' and boost the overall efficiency of the pension system, including improving returns for savers," Scottish Widows master trust lead and scheme strategist, Sharon Bellingham, says.

"It is likely that current proposals

would result in further DC master trust consolidation," Smart Pension CEO, Jamie Fiveash, says. "There is also probably greater scope for consolidation in the contract-based market if bulk transfers can be made easier, as is being proposed," he adds.

Yet at first glance the UK DC market already looks pretty consolidated, "with six major providers controlling approximately 75 per cent of the assets, alongside two master trusts with 'meaningful scale' *[Nest and The People's Pension both have AUM over £25 billion]*" Bellingham says, noting however that there is underlying market fragmentation within this.

According to TPR's *Occupational defined contribution landscape in the UK 2023*, since 2012, the number of non-micro DC schemes *[micro schemes have fewer than 12 members]* and hybrid schemes has declined by 70 per cent, from 3,660 to 1,080 *[see figure 1]*. In 2023 alone, the number of such schemes declined by 11 per cent, while the number of members increased by 9 per cent.

"Small schemes have been disappearing in the DC world and what we will start to see is the rise of the DC megafund," LCP partner, Steve Webb, says. "Partly, that's just because of the wall of money that's going to hit DC in the next five years. It's estimated that workplace DC assets will double to around £1 trillion over the next five years, meaning that DC megafunds would occur even without any government intervention."

Speaking in November last year, TPR CEO, Nausicaa Delfas, highlighted its modelling showing that, even without government intervention, the master trust market will contain schemes of systemically important size in 10 years' time.

According to its estimates, there will be seven schemes with more than £50 billion assets under management on a consolidated basis, four of which will be responsible for well over £100 billion each.

Therefore, as the DC market was already consolidating organically, and as the forthcoming value for money framework is designed to weed out schemes that aren't delivering, "the government might find its aims would be achieved as quickly, and without so much disruption, if it allowed the market to find the equilibrium", IGG head of policy and external affairs, Lou Davey, suggests.

"The economies of scale that may come with larger DC default investment funds could improve investment opportunities, yet proposals must consider the impacts of concentration risk and reduced innovation"

Creating DC megafunds would likely be a major undertaking, not least because, as things stand, there is some confusion as to what being a 'megafund' entails.

As Bellingham highlights, it currently remains uncertain whether the scale test should be applied at 'arrangement' level or the 'building block level'.

"For instance, cash or cash-equivalent building blocks – often used in the final stages of lifestyling – are typically much smaller. The impact on target-date funds could also be significant, where each maturity year has a different fund, meaning the design of these funds is crucial," she explains. Just what would happen to DC schemes that did not achieve scale by 2030 is also still to be determined, Bellingham adds.

DB consolidation

DC scheme size may currently be the centre of government attention, but the DB sector has not been exempted from the desire for larger-sized schemes.

Along with announcing plans for DC megafunds in her Mansion House speech last November, Chancellor Rachel Reeves also revealed requirements for the 86 Local Government Pension Scheme (LGPS) administering authorities to consolidate their assets into fewer, larger pools of capital.

As LawDeb Pensions managing director, Sankar Mahalingham, says: "The drive towards LGPS pooling is driven by a desire to reduce fees, increase efficiencies, and free up assets to be invested in local infrastructure."

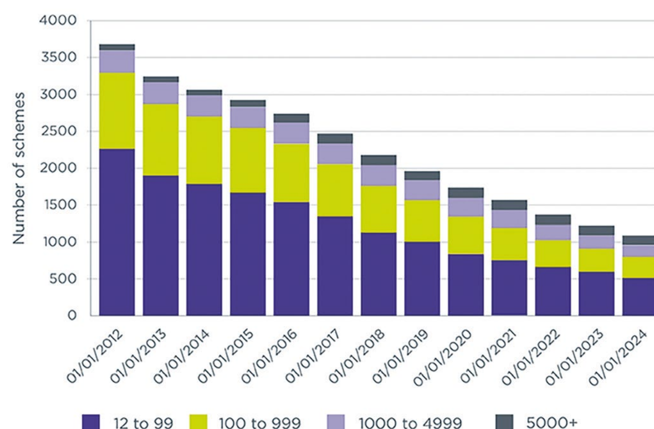
Following a slow start, DB superfunds, which consolidate the liabilities of its DB scheme customers and provides a large capital buffer in lieu of the employer covenant, is now beginning to take off, with the only regulator-approved provider, Clara Pensions, having announced three transactions between 2023 and now.

Last year, the Department for Work and Pensions also proposed the creation of a public-sector consolidator, run by the Pension Protection Fund (PPF), where the PPF would act as a consolidator for those DB schemes that are unable to find a willing commercial provider to secure its benefits.

"Superfunds have become a more appealing and viable option for schemes since the 2023 Mansion House reforms confirmed plans for a permanent superfund regulatory regime, Mahalingham says. "The government's renewed focus on this topic may well motivate new entrants to move at pace," he adds.

Broadstone head of policy, David Brooks, also expects that the healthier funding position of DB schemes in general will result in more schemes reaching buyout and transacting with either an insurer or commercial consolidator. "We would expect the consolidator to write more business as the industry gets more comfortable with

Figure 1: Occupational DC schemes by membership size group (including hybrid schemes, excluding micro schemes)



Source – The Pensions Regulator

that route as a viable alternative to an insurer," he says.

"For DB schemes, consolidation has more benefits and fewer drawbacks [*than DC*] as many schemes are approaching their endgame. As a result, we anticipate the conversation around consolidation will likely accelerate in the coming months as alternatives to a buyout," TPT Retirement Solutions, Phillip Smith, agrees.

However, the improved funding position for many DB schemes may mean that some that had been eyeing consolidating into a superfund may instead jump to being able to afford an insurer buyout, or they may decide just to continue 'running-on' the scheme themselves, if they are large enough with sufficent resources to do so.

"Given improved funding positions and the latest government proposals, more trustees will consider run-on," Smith says. "If schemes decide to run on, consolidation will enable them to benefit from increased diversification and better value through economies of scale, high-quality governance, and ongoing investment expertise," he adds.

However, while "some larger DB schemes may well see the benefit of continuing, and while the surplus assets will be large in aggregate, it is still likely to fall considerably short of the policy's stated ambition *[of pension schemes to be at least £25 billon in size]*", Brooks warns.

Indeed, Webb predicts the DB market will get smaller, not larger, over time.

"I think it is fair to say that, with a few exceptions, the number of DB schemes and DB money is going to go down each year," he states. "For most DB schemes, it has been decades since they had a new member. Existing members, not surprisingly, get a year older every year, and so more and more of the money needed to pay the pensions has actually already been paid out. So, even if a DB scheme is running on for 10 years, in many cases, it will be getting smaller and smaller every year."

Benefits

If both the DC and DB markets were naturally seeing a reduction in small schemes, what has driven the government and regulator push for faster consolidation?

"Scale undoubtedly brings benefits, particularly in DC, in terms of overall value for money and the ability to invest in a broader range of assets," Davey says. She highlights how it could enable schemes to build large in-house investment teams "that can invest directly in private markets, as well as reduce reliance on (and associated cost of) intermediaries and pooled arrangements", alongside potentially delivering high quality services and solutions for members.

Feeling positive about industry consolidation, TPR's spokesperson tells *Pensions Age*: "We welcome the bold reforms announced by the Chancellor at Mansion House, which will accelerate the move towards a market of fewer, larger pension schemes, better equipped to deliver for savers and invest in the UK economy.

"Consolidation across both DB and DC markets will encourage better governance and improved economies of scale, leading to better outcomes for savers."

Fewer, but larger, DC schemes may also generate further consolidation within the sector, in the form of collective DC (CDC) arrangements entering the UK – Royal Mail being the first such company in the UK to provide its employers with one, with its CDC arrangement launching in October last year.

DC megafunds "may encourage providers to offer CDC as a decumulation option as the scale required could be more easily reached", Brooks suggests.

On the investment front, Webb believes that "some will use their scale to bring investment in house. An obvious benefit of this is to negotiate better prices in the market, or to get the investment market to do things that it wouldn't have done for a smaller scheme".

"If they use their buying power effectively, they're paying less for asset management, or they can get more bespoke asset management, which I think has got to be good news," he adds.

Overall, TPP thinks the government's proposals for greater consolidation is "roughly in line with what the international evidence says about the effectiveness of scale as a driver of scheme performance. It's not a surprise that the government is looking at best practice overseas *[the Australian and Canadian pension markets]*, even if that could be challenging for the UK market".

Concerns

There is certainly a great deal of concern about the challenges generating larger-sized schemes could bring.

"The economies of scale that may come with larger DC default investment funds could improve investment opportunities, yet proposals must consider the impacts of concentration risk and reduced innovation," Smith warns.

Webb shares the concern over the lack of innovation.

"We all know where economies of scale sit, but do we know where diseconomies of scale come in?" he asks.

"If you are a £20 billion scheme, you've got a lot buying power. So, we can see why getting bigger up to a point is going to be more efficient. But do any of us really know what happens when you get to £100 billion? Does the scheme become unresponsive, bureaucratic, struggling to find places to invest its money? We just don't know whether issues will arise if pension schemes get too big," Webb explains.

Smith also highlights how the DC pension market in the UK "is already far more consolidated at the provider level than many comparable markets, and the government's proposed reforms could effectively lock out any new entrants to the market, resulting in an oligopoly of large schemes".

This oligopoly could limit innovation in areas such as digital and CDC, Smith adds, and so, "the industry should mirror approaches across other financial service sectors, whereby enhanced customer experiences at smaller firms challenge larger firms to improve".

"Scale undoubtedly brings benefits, particularly in DC, in terms of overall value for money and the ability to invest in a broader range of assets"

The time taken to implement forced consolidation may also be an "unhelpful distraction" from what would otherwise be a "natural transition in an already consolidating market", Davey states.

"Introducing uncertainty about potential mandatory consolidation may mean that existing plans to invest in private markets or innovation are put on hold, creating a perverse outcome to achieving government aims. Why invest now in assets that may need to be sold with a haircut if a scheme is forced to consolidate at an inopportune time?" she adds.

Davey also notes that there will be a limited supply of quality, UK-based investment opportunities that LGPS, DB and DC megafunds will all be competing for, and "not everyone will be able to secure the best opportunities".

Whether the minimum pension fund scale of £25 billion AUM desired by the governments for DC megafunds will drive any substantial additional investment diversification or any increased investment in UK productive assets, let alone deliver better saver returns, is unclear, the SPP warned in its response to the government's consultation on the proposals.

"An important distinction to make is between master trusts and single employer trusts," Webb says. "You've got traditional employers, who run their own scheme for their own employees, and some of those are quite big, multi-billion-pound schemes, but the government's talking about master trusts having to be over £25 billion in size.

"So, there's a question as to what the government's agenda is for. For example, a bank's excellent pension scheme, which might 'only' be £5 billion, does the government say, 'well, that's too small. All pension schemes have to be megafunds', when actually it could be a very well run, very well invested scheme, investing in the sort of things the government wants pension funds to invest in?"

The SPP has suggested £5 billion

Small pot consolidation

It is not just within the pensions industry itself where fewer, larger schemes is desired; for the members themselves there is a push to encourage consolidation of any multiple, small pension pots they may have accrued over their working lives.

"The proliferation of these deferred small pension pots is burdensome for both pension providers and savers. Fixed costs of administering a pot lead to higher charges, and lower returns, for savers," Institute for Fiscal Studies research economist, Laurence O'Brien, stated to *Pensions Age* last month.

To solve this problem, O'Brien highlighted the case for the automatic consolidation of deferred small pension pots, with the option for individuals to opt out if they wish.

This, he suggested, could be achieved by individuals who have more than one pot with the same pension provider having all these pots automatically consolidated into the pot that represents the best value for money.

When there are a number of different pot providers, O'Brien suggested that "the two most sensible choices would be either one of a set of government-approved consolidators (the 'multiple default consolidator approach') or a member's current pot (the 'pot follows member' approach)".

AUM for DC schemes, with an agreed glidepath to larger scale over a longer timeframe *[than the government's proposed 2030 by the earliest for DC megafunds]*.

"Whether the minimum size is £5 billion or £25 billion, this could clearly stifle the emergence of CDC and other innovations if there are no meaningful exemptions," SPP president, Sophia Singleton, says.

"That's why the SPP has asked for a broad exemption for smaller funds that outperform their larger peers; an exempt growth period during which time any new arrangements can focus on building scale; and exemptions for schemes that serve niche markets such as Sharia-compliant default arrangements and CDC schemes," she adds.

Knock-on industry effects

Putting concern aside and assuming the creation of DC megafunds does go ahead, the effect may be a "frenzy with providers (and their backers) jostling for elbow room as they aim for the magic £25 billion number", Brooks warns.

"As the market transitions to a more consolidated landscape, it will be incredibly important to ensure that reforms are enacted in a way that avoids undue disruption," Bellingham adds. "It will also be interesting to observe how the scale threshold for providers will influence decision-making and market activity; ensuring that a pension provider can demonstrate commitment to the market is a key consideration for any employer or trustee board."

If DC consolidation is forced over a short timeframe proposed, for employers, it will inevitably increase the costs of pension provision across several areas, including procurement, HR, payroll, finance, and professional services, Smith says. "This will be an unwelcome additional expense for firms and further emphasises the need to deliver the value-for-money framework."

However, providers would likely benefit in the shorter term, with greater demand for advisers and trustees to help schemes navigate through this journey, Mahalingham states.

"We have to remember that 'short term' in the pensions world means a decade, and it will take a decade for the types of consolidation we are talking about to play out," Fiveash points out.

"That will mean much more work over the next decade, not less. Yes, perhaps at that stage innovation will be required, and models may need to change, but the UK market is still growing rapidly in terms of assets and customers.

"If we reach the stage when consolidation reaches a conclusion, I have little doubt there will still be a need for great people to keep working towards better delivering pension savers' outcomes. Perhaps at that stage it may be less about growth in provision of services to employers and schemes, and more toward serving the millions of DC savers heading toward and reaching retirement," Fiveash elaborates.

Yet the potential for conflicts within providers may be higher because of consolidation, as firms operate across a smaller number of schemes, Davey says.

"However, with the increased complexity of managing schemes of the scale envisaged by the government, we may see growing demand for larger teams of highly skilled professionals – professional trustees, governance providers and advisers," she continues. "Ultimately, I don't see the demand for increased professionalisation of trusteeship and governance diminishing – quite the opposite."

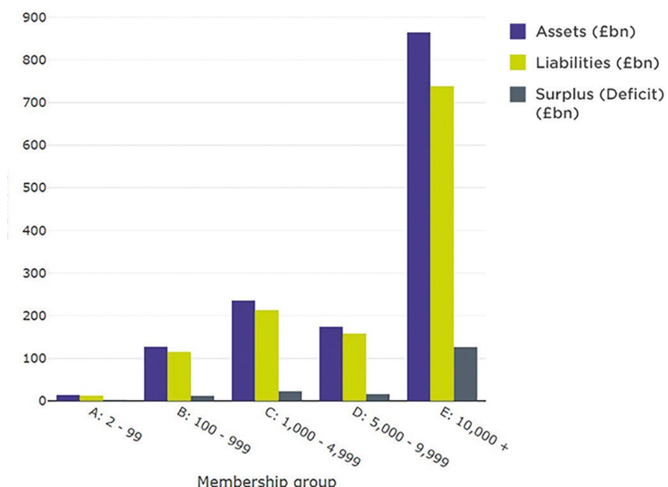
In contrast, Webb highlights how the number of scheme advisers etc is likely to reduce as result of consolidation, as "five pension schemes may need five actuaries; one pension scheme does not need five actuaries".

Therefore, for future proofing, industry providers are increasingly diversifying. Webb gives the example of professional trustees providing consultancy-type work, or consultants providing research and analytics.

Speaking in November last year, Delfas noted that the broader pensions market has become "increasingly concentrated", with 47 administrators covering 90 per cent of memberships and 10 professional trustee firms accounting for well over £1 trillion of assets.

In response to such industry change, TPR has announced that it is moving

Figure 2: Estimated technical provisions funding figures for DB schemes as at 31 March 2023 by membership group (excludes schemes winding up)



Source – The Pensions Regulator

The number of UK DB schemes per year

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Number of DB schemes	7,297	6,974	6,657	6,396	6,206	5,973	5,805	5,701	5,604	5,522	5,378	5,297

Source – The Pensions Regulator

towards a more prudential-style of regulation amid a 'rapid' acceleration in the scale of workplace pension schemes.

TPR's spokesperson tells *Pensions Age:* "We continue to adapt to this new and exciting pensions landscape and are playing a pivotal role in government and industry-wide initiatives and policy making. These opportunities encourage innovation in the market and are one of the reasons we are setting up an innovation hub."

Future impact on members

Throughout all this consolidation and innovation, members need to remain the essential ingredient blended into the industry's 'supersizing'.

After all, "scale can offer many benefits for members, from enhanced digital support, wider expertise in contact centres, and lower management fees, as providers can use their size to invest in a way that is scaled across a wider population", Mahalingham says. "However, oversight and governance is key, to make sure these 'megafunds' are delivering the promised benefits to members."

Webb acknowledges that it is a challenge for master trusts to provide something that is exactly right for each type of its customers' workforce. So, even within master trusts, 'bigger' once again means 'more powerful'.

"What tends to happen is big employers can negotiate something a bit more bespoke for their workforce within the master trust, something a bit more customised," he explains.

Brooks shares his concern that the increase in private market investment, which consolidation is expected to bring, could "occur without the members noticing (not to say they won't be told)".

He explains: "Member charges will increase with no guarantee of greater returns. This is of great concern as the language of cash, credit, gilts and equities gets a further allocation to something members may understand even less. 'Is that right?' will be a fundamental question."

We'll need to look to the future to answer that question. Twenty years on, will consolidation have the same impact as the *Super Size Me* film had on the fast-food sector, by ultimately helping to improve practices for the end user?

"The government might find its aims would be achieved as quickly, and without so much disruption, if it allowed the market to find the equilibrium"

The ramifications of consolidation will almost certainly be felt over the decades, but scepticism abounds as to whether this will benefit pension schemes, and DC scheme members particularly.

The government's own modelling last year found that the expected increase in private market investment that fewer, larger pension schemes is hoping to bring, will only provide a 'slight' improvement to member outcomes.

The Government Actuary's Department (GAD) stated: "Our analysis showed that a greater level of exposure to private markets may deliver slightly improved outcomes to members. However, there is considerable uncertainty, particularly with the assumptions for projected future investment returns."

Singleton says that the SPP agrees "with the government's own consultation document, which states, 'the evidence linking pension provider scale and gross investment returns is mixed'".

"The move to scale will reduce competition, will likely stifle innovation and will consequently detract from member outcomes," she adds.

"There's a huge cost to all of this consolidation," Webb agrees. "Every time pension schemes merge, move data onto new platforms, get all the legal processes, communicate to members etc, all of this comes at a cost, and that all has to be quantified. So, there is a risk, I think, that the member gets forgotten because the government wants to use the pension money for its own objectives."

Brooks shares this concern about the member experience.

"If we fast-forward 20 years, if the [*DC megafunds]* policy is enacted, I would not expect there to be much to tell between the handful of DC providers that exists," he states.

"All will be held to the same standards and largely they will be investing, communicating and decumulating in similar ways so that it probably won't matter who the member is with, in a pseudo-nationalisation of the DC system.

"I suspect the industry would dislike that, on the whole, as it could stifle innovation and differentiators of service and performance, ultimately leading to poorer outcomes, albeit simplifying the pensions system."