COLUMBIA THREADNEEDLE INVESTMENTS

Consolidate with caution

Too much focus on scale could come at the expense of innovation

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- **Chancellor Rachel Reeves is right to identify excessive risk aversion as a critical issue in UK pensions.** Consolidation is her answer.
- **While boosting scale via consolidation is helpful, it is no magic wand.** UK pensions already compare well on costs; reducing the UK to a handful of 'megafunds' could result in more herding, less competition and less innovation.
- **Instead the focus should be on reforming the regulations that created the risk aversion in the first place,** especially those rules not found in other countries.

Last month, in an attempt to boost the UK's growth trajectory, Rachel Reeves unveiled[1] what she claimed was the "biggest pension reform in decades". She reckons the UK has been regulating for risk, but not regulating for growth – a view many in the industry would agree with.

So what is the chancellor proposing? She thinks that to increase risk taking and appetite for growth, the UK needs to increase the size and scale of pension schemes. For example, within defined contribution (DC) pensions she has floated the idea of a £25 billion-£50 billion minimum level of pension scheme assets in order to achieve the size the government thinks will drive investment into the domestic economy.

Will this approach work? Will creating megafunds tackle a system that, in her words "sought to eliminate risk taking"?

Radical reforms – but will they work?

Reeves is certainly prescribing strong medicine. Today, there are around 20-30 DC master trusts of the sort the chancellor was talking about. Of those, only three meet Reeves' £25 billion size threshold.

So her proposed floor will mean a considerable amount of consolidation in the industry, with expectations that the government's vision is to concentrate on a handful of surviving schemes.

By contrast, in Australia – a country whose successful superannuation funds were referenced multiple times in her speeches – their regulator is rumoured to be pushing for a minimum size of A$30 billion (around £15 billion), ie much lower than the UK's proposal. That's in the context of a mature superannuation industry where at least two dozen funds already meet that threshold, and where around 150 under-threshold funds are waiting in the wings.

Combined with the greater contestability in Australia (league tables of performance, ease of switching providers) the result is a marketplace of ideas, with certain funds able to differentiate by reference to their superior environmental, social and governance (ESG) credentials, while others focus on lower costs, better performance or their innovation.

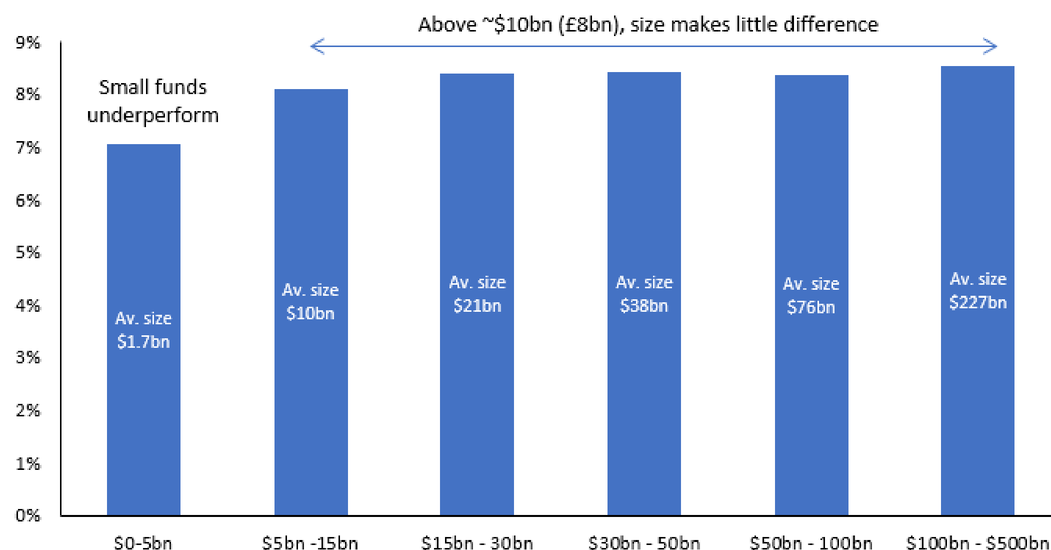
By contrast, the implications of the much higher threshold floated by Reeves could leave the industry with just a handful of megafunds, with a corresponding degree of concentration risk, herding of investment approaches and little competitive pressure.

Regulators should also take care to plan the pensions industry with an eye on the long term. The larger population of the UK will mean that in the decades ahead the DC master trusts could overtake the Australian superannuation system in total size. Deploying what will become a huge pool of capital in productive ways may be easier with a multitude of scheme sizes rather than fewer larger funds all fishing for the same large opportunities.

Is lack-of-scale the issue?

Perhaps more importantly, in our view scale itself is not the underlying cause of the risk aversion in the UK pension industry. In fact, it is entirely possible to have large funds that are very defensive or small funds investing in growth-orientated projects. And evidence from around the world suggests only a modest link between scale and performance (Figure 1).

Figure 1: Megafunds perform no better than mid-sized, but micro funds underperform (10-year average return, by size of fund)



Source: publicplansdata.org. Data from US public pensions, sample size of 218 schemes for the 10 years ending 2022

Will focusing on costs help?

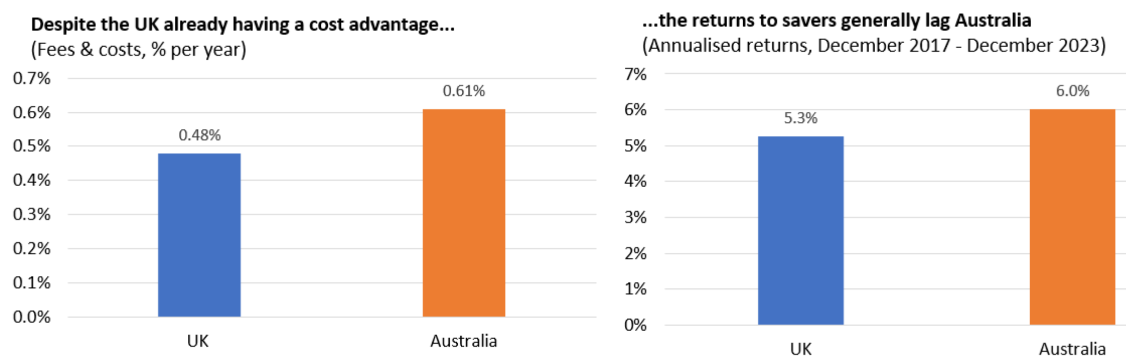
Scale can help reduce fees and boost efficiency. Every pound spent on administration is a pound less for savers. So it is better to spread those costs over a wider base. But, like any view, it is an argument that can be taken too far.

Already, UK DC pensions cost less than the world class Australian superannuation funds. Research from Policy Exchange shows how the costs for UK DC auto-enrolment schemes come in at about 0.48% versus 0.61% for Australian schemes. Despite this cost advantage, UK savers generally see lower long-term returns (Figure 2).[2]

The same report highlights that this lower performance to UK pension savers disappears when comparing similar risk profiles. Instead, the lower returns come from UK-specific regulations that force more savers to be classified into lower risk/lower return categories.

Equivalent rules are not so strict elsewhere in the world, including in Australia (see section on lifestyling below). Cutting costs is a help but no cure for this regulation-driven risk aversion.

Figure 2: Lower costs is not a cure-all for risk aversion



Source: Policy Exchange, August 2024

Back to basics: time to tackle risk aversion

Rather than focusing on scale, it is worth recapping how the risk aversion highlighted by the chancellor came about in the first place. For many it dates back to an era when defined benefit (DB) schemes were often in the newspapers for all the wrong reasons. This created a culture of “safety first” regulations and investment approaches that are near universally accepted in the UK but see far less support elsewhere in the world.

The knock-on of these extra rules to the DB system is well known. Those schemes invest with a preponderance of low-risk gilts and in aggregate have only 11% in equities – with only a fraction of that invested in the UK. Less well known are the issues in the DC system, in which costs and risk rather than performance outcomes or innovation tend to be the priority.

As the assets of the DC world will soon overtake those of the DB world, it is worth looking in detail at an example from the former to see how these rules driving the risk aversion come about.

Lifestyling: too much risk reduction is a bad thing

One example of rules behind the excessive risk reduction highlighted by our own research is the UK's adherence to the concept of lifestyling – an idea that progressively lowers equity allocations as savers get closer to retirement.[3]

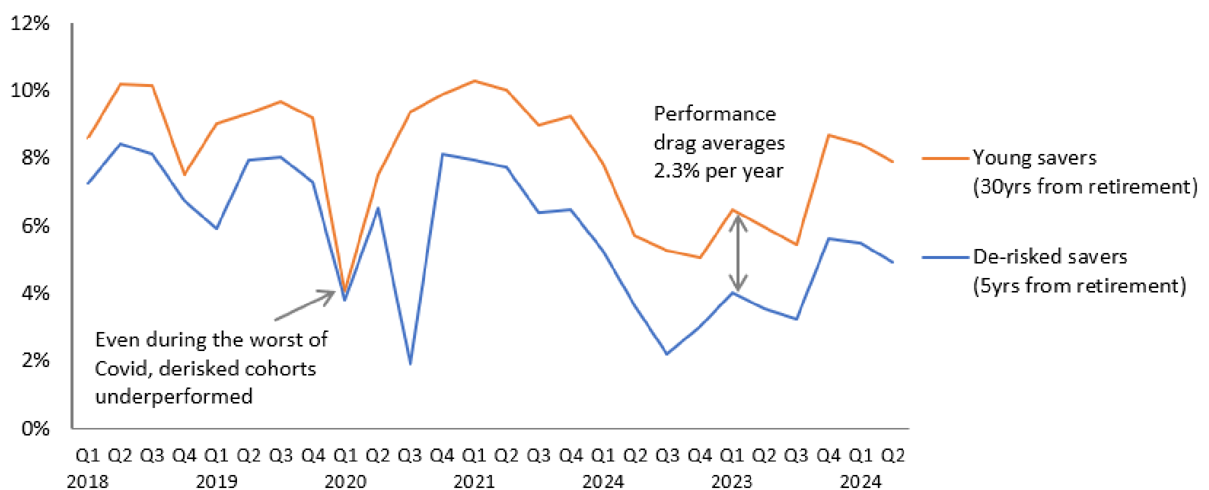
The theory around lifestyling is anchored in the legacy requirement to purchase an annuity in retirement. Yet despite this rule being scrapped in the 2015 Pension Freedom reforms, UK regulators still tacitly endorse the theory and require a degree of adherence.

Other countries avoid this type of derisking. Australia's famous superannuation funds have trustees that face the same fiduciary duty as in the UK and the same duty to run their schemes with appropriate risk profiles. But unlike in the UK, Australian trustees have a free choice as to whether or not to adopt lifestyling. Most (67%) choose to avoid it.

The difference between the Australian and UK approaches to prioritising risk wouldn't matter if the results from lifestyling were good. Sadly for the UK, the results of the theory leave a lot to be desired (Figure 3).

Since the data began, every five-year period has seen worse returns from the derisking approach. This includes the five years ending March 2020 (the period with the biggest Covid market impacts) where the derisked older cohorts saw worse performance than their younger counterparts (3.8% versus 4%).

Figure 3: Derisking consistently delivers lower long-term returns
(Five-year returns to the end of the period, % p.a.)



Source: Corporate Advisor Master Trust data, 2024

Our research shows how the drag from that one rule alone works out to £12,000 to a typical £100,000 pre-retirement pension pot. And for the country, the lower equity allocations mean a £25 billion hit to domestic investment and UK capital markets.

It is time to look again at such safety-first rules that see far less support elsewhere in the world.

Conclusion

In our view, Rachel Reeves has the right diagnosis but needs to be careful not to overdo the medicine. Yes, pensions are too defensive and don't invest enough in growth. But it isn't lack of scale that is the biggest issue holding pensions back. It is the detailed regulations that stem from a "safety-first" culture built up over many years.

The proposed changes do represent a serious attempt to improve outcomes for DC savers. Scale can bring better governance and decrease the large variability of outcomes experienced in the UK.

But consolidation needs to be handled with care and can be taken too far. Scale brings benefits but also risks. If taken too far it could leave a handful of megafunds, with a corresponding degree of concentration risk, and can encourage herding. This could reduce contestability and innovation, especially in the decades ahead when the schemes will be so much larger than they are today.

Beyond scale, we think it is also time to adjust risk-focused regulations to allow a more proportionate view of risk and return. Unless those underlying rules are tackled, the Reeves reforms might result in a few very large pension schemes, facing little competitive pressure, still with defensive allocations, with both savers and the country missing out.

Notes and sources

[1] Gov.uk, Chancellor fires up financial services sector to drive growth, 14 November 2024

[2] Policy Exchange, Growing Pensions Capital: Lessons from Australia, 2024

[3] Columbia Threadneedle Investments, Lifestyling: the Achilles heel in DC pensions, November 2024

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