Freedom and choice in pensions

Response from NEST

Overview

The recent liberalisation of the rules on decumulation present us with a welcome opportunity to think about what our members need from their pension provider as they make choices about income in later life and consider the guidance they might need to make these choices.

About NEST

NEST is a trust-based occupational pension scheme. We were set up to make sure that every employer would be able to enrol their employees into a qualifying pension scheme following the introduction of automatic enrolment. Automatic enrolment is a policy response to inertia, and draws heavily on lessons from behavioural economics. After failed attempts to engage consumers through an 'informed choice' approach it was recognised by the Pensions Commission in the 2000s that defaulting workers into saving would be more successful. This has been proven to be the case with less than 8 per cent of workers opting out of saving in NEST. It is worth noting that this process is ongoing with millions of workers in small companies to be enrolled by 2017.

Currently the NEST scheme has over 1.2 million members and over 7000 participating employers. NEST's members are low to moderate earners and are often saving for the first time. This is a new market of savers who have not been well-served by the pensions market to date and have a history of very low engagement with retirement savings.

The scheme has a lot of members, most with small or very small funds. The scheme also has a low median age, with the majority of our members being under 40. Their contribution rates are largely low as this is a function of the low initial contribution rates set at the start of automatic enrolment, currently 2 per cent of qualifying earnings, rising to 8 per cent in 2018. For the overwhelming majority of those who retire in the next few years, taking their fund as cash will likely be the most sensible and tax-efficient option. However this will change over time.

NEST has a Members' Panel who are independent of NEST and were consulted on this response.

The guidance guarantee and associated funding

The immediate challenge with the guidance guarantee is for the industry and government to act quickly to ensure there is a model up and running for April 2015, and that this model is proportionate to the needs of those using it. Whatever the role for provider-delivered models, we do not believe that a simple requirement on individual providers is sufficient, appropriate or deliverable to meet the needs of all savers in this timeframe. A tightly defined, third-party provider-delivered model seems to us to be a necessary feature of any guidance guarantee landscape. However our emphasis is very much on 'tightly defined'. We note the cross-industry risks and expense that could be incurred by a solution that strays beyond basic guidance.

In light of the nature of NEST's membership - both in terms of pot size and typically low engagement - an important concern for NEST is how we and the government can make sure that delivery of the guidance guarantee represents value for money and is flexible in light of the very early understanding we have of the needs of these new cohorts of savers. We need to think carefully about how to fund the guidance such that it does not result in those with the smallest funds, who have also got the simplest guidance needs, cross subsidising those with larger funds and more demands. Avoiding a blanket and potentially expensive requirement on individual providers will help with this. But it is also important that the funding of any third-party solution is fair on savers. We believe that a levy across the financial services sector would be most equitable, perhaps based in some way on the volume of assets being decumulated. This would reflect the facts that consumers are likely to buy a variety of financial products in retirement and that those with the smallest pots are likely to have the simplest guidance needs.

Consideration could also be given to a *de minimus* or triviality rule with respect to guidance as those with very small pots are likely to continue to take them as cash, as they do now. More broadly, retirement will increasingly be a process and not an event. One-off guidance is unlikely to be sufficient for the needs of many savers and could encourage some into an inappropriate one-time decision on decumulation.

On the question of impartiality, we should be wary of the low levels of consumer confidence in the financial services sector. Globally, banks and financial services sit at the bottom of a list of industries that consumers trust to do what is 'right'[1]. This potentially underlines the benefit of near-term third-party provision of the government's guidance guarantee but shouldn't deter us, as providers, from working hard on building meaningful engagement with our members over the longer term.

'Good' innovation in the retirement income market

While people may become more engaged with their pension savings at retirement, there is good evidence from the accumulation phase to suggest that people will be inert and that they may find choices at retirement confusing and difficult. It should be possible to produce a choice architecture that preserves both what we have collectively learned about how people take complex financial decisions with the government's intent to give people a free choice at retirement. We think that well-designed default retirement pathways, contrived so people can step off them at any time should they wish to make choices later on, merit further consideration.

NEST is planning to consult in the autumn on what we can do to assist our membership on the run-up to and through retirement, such as through the provision of different investment journeys and post retirement vehicles. The purpose of this is to evaluate whether there is a case based on the distinctiveness of our membership for a tailored decumulation approach to be developed and if NEST can act as an informed institutional customer of significant scale in the wholesale decumulation market.

This is a market in which the demand-side has typically been weak, and suffered from information asymmetries. While guidance can go some way towards addressing this, the Treasury is right to consider how we can make sure that product development works in consumers' favour. We think an alignment of interests and good governance is important here. Trust-based schemes and those with independent governance committees should be active in considering the distinct and specific needs of their membership. For NEST, serving cohorts of new savers among low and middle income groups, we should not assume that what has previously been considered 'good' innovation or 'suitable' products for those on higher earnings will still be appropriate for this market.

[1]Edelman Berland (2013) 'Edelman Trust Barometer: annual global study'. Available at **www.edelman.com**

Consultation questions

A.1 The government welcomes views on its proposed approach to reforming the pensions tax framework.

1 Should a statutory override be put in place to ensure that pension scheme rules do not prevent individuals from taking advantage of increased flexibility?

NEST cannot see a reason to limit individuals from taking up the new flexibility. The only note of caution is to bear in mind that Trust based schemes have a degree of discretion. The government may wish to preserve this. An example would be that pension schemes do not operate with the flexibility of, for example, bank accounts. Therefore schemes may want to direct savers away from creating unacceptably high operational costs, for example weekly withdrawals. NEST has a duty to ensure that the scheme operates well for all members.

2 How could the government design the new system such that it enables innovation in the retirement income market?

For NEST, the important question is what does 'good' product development look like for our distinct membership, the needs of which we are only just beginning to understand. These are largely new retirement savers, the majority of whom will have small pots over the medium term. To date they have also been difficult to engage. This is apparent in the fund choices our members make, as 99.8 per cent of savers in NEST stay in the default fund rather than move their money into one of our other fund choices. A very small proportion actively sign up for online communication after they receive their member welcome pack in the post.

This suggests the government needs to consider what features of the market will make sure that product design is driven by members' interests. A strong demand-side seems unlikely, even beyond the next few years. However excessive regulation of the supply side could have the consequence of limiting the scope for positive product change.

We think this highlights the role for well-governed suppliers to develop solutions in the member interest. Trust-based schemes and new independent governance committees in the contract-based sector clearly have a role to play here in demonstrating that they can oversee changes in the product that are truly aligned with the needs of the savers they serve. Government could therefore provide a regulatory backdrop that enables schemes to understand and interpret their own membership and what flexibility really means for them.

We are planning to consult in the autumn on what we can do to assist our membership in the run up to and through retirement, such as providing different investment journeys and post retirement vehicles. The purpose of this is to evaluate whether there is a case, based on the distinctiveness of the membership, for a tailored decumulation approach to be developed and if we can act as an informed institutional customer of significant scale in the wholesale decumulation market.

3 Do you agree that the age at which private pension wealth can be accessed should rise alongside the State Pension age?

The underlying logic of the pension reforms that have followed the Pensions Commission's work in the early 2000s is to create a framework in which individuals transfer greater wealth into later life. As a pension scheme concerned with the later-life incomes of its members, we believe that the two age thresholds should track one another. We note that current flexibilities for those with ill health should continue.

4 Should the change in the minimum pension age be applied to all pension schemes which qualify for tax relief?

With respect to DC schemes, given the objectives of the Finance Act 2004, which introduced sweeping reforms in the pensions accumulation space unifying the accumulation regime, it should follow that all tax-approved pension schemes work within the same framework, including the minimum pension age.

5 Should the minimum pension age be increased further, for example so that it is five years below State Pension age?

We think there could be good reasons for increasing the minimum pension age, especially if there is early evidence of savers accessing their pots early and not benefitting from a longer period of pension saving with employer contributions.

Supporting choice (Chapter 4)

A.2 The government welcomes views on its proposed approach to supporting consumers in making retirement choices.

We believe there are two distinct challenges being raised by the government. The first is how pension providers can support savers in making choices in response to the new flexibility from April 2015. The second is a longer-term challenge. As automatic enrolment creates a shift in private retirement saving, and new generations of savers are independently preparing for their own later life, how do we create meaningful engagement? Choices that affect retirement will be made over a much longer duration than the point at which the saver chooses a later-life financial product.

On the first challenge, the biggest hurdle here is putting a flexible guidance solution in place by April 2015. There are some cross-industry risks that the government will need to consider in reaching a view.

- Take-up is very unpredictable. Having spoken to pension schemes in Australia and Denmark where consumers have more flexibility in their retirement income choices, we note that the take up of - sometimes very comprehensive - free advice is limited, even when consumers have significant pension pots. This suggests that take-up could be very low, and yet hitting a capacity constraint that leaves many savers unable to access guidance would clearly not be acceptable. Leaving this delivery risk to individual schemes could be costly and inefficient.
- The balance between 'guidance' and 'advice' is difficult to strike. Straying into regulated advice introduces risks to the industry, and ones that will endure over time and may evolve as regulation continues to shift. Consumers would bear the costs of mistakes, which again underlines the need for the FCA and the Financial Ombudsman Service to agree to a tightly defined guidance solution for the guarantee from April 2015.
- Providing true value for money. The guidance needs of those with the smallest pots - a growing number of people as automatic enrolment rolls out - will be modest. They may need information about the tax and benefit systems and the State Pension. They will also require information about work and, potentially, working longer. This group will not be well served - and in fact their needs could be undermined - by a more sophisticated and potentially more expensive approach. Indeed a *de minimus* or triviality rule could be considered - perhaps for those with savings up to the current trivial commutation limit - to ensure that they do not end up having to fund guidance models that are over-specified for their needs.

The consultation document suggests that there will be a duty on providers and schemes to deliver the 'guidance guarantee'. We believe that any duty on providers should not be prescriptive given the different characteristics of the memberships of these schemes. In light of the near-term delivery challenge and the risks above, we are in favour of a third-party delivered solution with a narrow scope. It is also important for this to represent value for money for NEST's members, the overwhelming majority of whom will have very basic guidance needs over the next few years. We believe that the most equitable manner of funding the guidance would be a levy on the financial services industry as a whole. Many different industry players are likely to profit from liberalisation, such as those offering buy-to-let mortgages, those developing new drawdown products, the advice community and annuity providers. We think that organisations benefitting from the decumulation phase should have a similar role to funding the guidance as those funding the accumulation phase. Basing the levy simply on the numbers of customers or savers could also be too simplistic and have unfair distributional consequences. Consideration should be given to calculating the levy based on the volume of assets held or of those assets eligible for decumulation as this could help ensure those with simpler needs do not shoulder a disproportionate degree of the costs.

In the longer term, there needs to be room for providers to meaningfully engage with their members over time. This might look different to offering guidance, but understanding their needs, and constructing suitable retirement product pathways and communication channels are likely components of a long-term response.

6 Is the prescription of standards enough to ensure the impartiality of guidance delivered by the pension provider? Should pension providers be required to outsource delivery of independent guidance to a trusted third party?

We need to draw a distinction here between 'guidance' - where impartiality for member-specific guidance will always be a challenge for providers who have products to sell and operational and financial considerations - and ongoing engagement. NEST's Members' Panel noted the difficulty in providing impartial guidance if the body also has retirement products to promote. As a trust-based scheme, we are impartial insofar as we have a duty to make decisions that are in our members' interest. But 'impartiality' at the level of our membership base does not necessarily equate to an ability to offer 'impartial' advice for each and every member. If this question refers specifically to the delivery model for the government's guidance guarantee, then as above, we think there are good reasons to suggest that the guidance should be tightly defined and delivered by a third party.

However there is also an important role for well-governed schemes to really understand the needs of their members, and engage with them over the longer term.

7 Should there be any difference between the requirements to offer guidance placed on contract-based pension providers and trust-based pension schemes?

We have no further comments to make beyond those in answer to the previous question.

8 What more can be done to ensure that guidance is available at key decision points during retirement?

Increasingly it will become more difficult to point to a single, critical, retirement decision and instead we will need to help people take a series of different decisions beginning in their 50s and lasting into their 80s. Indeed consumers may change their retirement income product over time. For example, starting out with a drawdown product and then using the remaining capital to buy an annuity later on in life. For those who choose not to make a choice, NEST will need to ensure default pathways are available.

We think that it is too early to set out what the support or guidance requirements should be over the medium term. We need to understand the needs of new cohorts of savers, deliver products that suit them and then consider how we engage with them to make sure they follow the best savings journey.

However, we think that there are three principles that should inform the development of future support and guidance.

1. It has to offer value for money for the member. Funds for support and guidance in trust-based schemes will ultimately be paid for by members. Guidance needs to affect member behaviour in a beneficial manner if it is not to be just another drain on members' incomes in retirement.

2. Support and guidance requirements should evolve along with the market and should fit with the choice architecture offered at retirement. For example if a provider offers a retirement path that converts from an accumulation phase to drawdown and then to annuitisation in late retirement then we can identify three or four different points at which support might be required.

3. Once an initial post-2015 guidance model is operating, it should be evaluated as a pilot and subject to the same level of research and evaluation as the rest of the pension policy consensus which underpins automatic enrolment and NEST. In particular the quality of the guidance given should be assessed.

Defined benefit schemes (Chapter 5)

A.3 The government would welcome views on the options outlined in point 5.15, including their likely complexity, and the burdens they might place on scheme sponsors and HMRC.

We have no comments to make.

9 Should the government continue to allow private sector defined benefit to defined contribution transfers and if so, in which circumstances?

We have no comments to make.

10 How should the government assess the risks associated with allowing private sector defined benefit schemes to transfer to defined contribution under the proposed tax system?

We have no comments to make.

Financial markets and investment (Chapter 6)

A.4 The government would welcome views on any potential impact of the government's proposals on investment and financial markets.

We have no comments to make.