NATIONAL EMPLOYMENT SAVINGS TRUST

# Meeting future workplace pensions challenges

NEST response to the Department for Work and Pensions consultation document

## Executive summary

The Department for Work and Pensions (DWP) consultation document on improving transfers and dealing with small pension pots seeks to address a range of issues relating to the transfer of pension pots in a post-automatic enrolment world. We see these issues as breaking down into two key points.

1) How to help ensure individuals are able to consolidate pension savings built up through multiple jobs.
2) How to help schemes manage or avoid the costs associated with administering small pension pots left behind by workers who move.

Both issues are important. A solution to the first is a necessary step towards the Government's aspiration for savers over time to reach retirement with 'one big fat pot'.

A solution to the second ought to make the market more efficient and drive out costs. The consultation document also establishes a link between solving the second issue and the removal of Short Service Refunds (SSRs).

We support the Minister's aspiration for savers to reach retirement with 'one big fat pot'. However, we believe there are significant challenges in getting there on a model that leans heavily on driving up the number of transactions between different schemes and providers. These challenges centre on the cost and risk to consumers.

Because of this, we believe that completely achieving the 'one big fat pot' ideal may be a longer-term goal. This raises the question of whether there are steps that could be taken now to move towards it in the nearer-term without overly restricting the scope for more fundamental change later.

We believe that at least one such approach exists (although of course there may be others). It can be implemented quickly and would be a 'no regret' option with respect to any longer-term goals around consolidation. This approach is based around the idea of 'two rights and a responsibility'.

- The right for all individuals to choose to pull their pot with them when they move. This includes choosing an alternative destination scheme if their current scheme instigates a 'push'.
- The right for any qualifying scheme to choose to push a pot away when a member leaves the employment that was associated with that scheme.
- The responsibility on at least one provider that meets certain quality conditions, to accept any transfer instigated by a scheme or an individual.

This would provide the basis for greater aggregation now, in ways that support more all-encompassing models for consolidation later.

## Introduction

NEST is the scheme established by the Government as part of its reforms to UK workplace pensions. NEST was set up to provide high-quality, lost-cost pension provision to those without such access.

In particular this means people new to pension saving, high-churn workers and those working for employers who were unattractive to the existing industry. As a trust, NEST is required to take decisions in the interests of its beneficiaries – the members of the scheme.

In the context of this consultation our role in implementing policy and our requirement to protect the interests of our members are both important. We note the view of some commentators that there may be some natural common ground between the policy intent of this consultation and an extended role for NEST as an aggregator of small pots.

We question whether the foundations for more complete consolidation through a 'pot follows member' model as a defaulted or automatic option currently exist without the risk of consumer detriment. This may suggest an aggregator-like model presents the best opportunity for early progress in this area.

However, we also believe it's essential that any approach to using NEST as an aggregator, should the Government choose this route, must be designed to protect members of NEST from the potentially significant cost implications that would arise from such an approach.

Whatever the preferred approach, the timing of any change is important. The introduction of automatic enrolment will cause a significant increase in the numbers of small pots being created. The sooner a plausible solution to that exists, the better.

In addition, as people interact with pensions for the first time, developing trust in pensions and providers will be critical. Leaving individuals with small sums of money with multiple providers is unlikely to help to build that trust.

## Overview and aims of the policy

The consultation document sets out the need to ensure defined contribution (DC) pension saving stays within pensions and sets out the incompatibility of Short Service Refunds with this goal. The focus of the policy options in the paper is then on addressing two issues.

1. How to help ensure individuals can consolidate pension savings built up through multiple jobs. The current process for transferring pensions can be complex and long-winded, discouraging the aggregation of pension pots.

   This is a consumer-driven question about how best to make it possible for individuals to consolidate their retirement savings. An important theme of the consultation is the possibility of making transfers of small pots 'automatic'.

2. How to help schemes to manage or avoid the costs associated with administering small pension pots left behind by workers who move. While managing this issue also has a consumer benefit in driving cost out of the system, there exists a second driver for this process in the simplification of administration and economic gains for transferring schemes.

NEST supports the aims of the consultation document in addressing these questions.

We agree that:

- without additional steps being taken, the combined effect of automatic enrolment with the removal of Short Service Refunds will be the creation of large numbers of small pension pots and this creates problems for both consumers and schemes.
- a saver's best interests will often be served by consolidation of their pension savings in a smaller number of schemes through their working life. Enabling consumers to aggregate their pension savings simply, in good quality pension schemes, can only drive positive outcomes. The long-term aspiration for members to reach retirement with 'one big fat pot' is difficult to dispute.
- there are benefits for schemes in being able to make a default transfer of small pension pots left behind by the worker.

However, we're concerned that some of the options set out in the consultation, in pursuing these aims, introduce new and potentially significant risks.

- Measures may be necessary to ensure that the consumer benefits outweigh the risk of detriment in requiring their pots to be transferred, or where such transfers are defaulted with an 'opt-out' for savers (at least where those transfers relate to larger pots). This is particularly prevalent when considering the possibility of making transfers out compulsory in a 'pot follows member' model, which could restrict member choice and risks member detriment.
- We're concerned that any model based on a very large number of transfer transactions runs the risk of introducing substantial new costs into the system. A 'pot follows member' model could introduce as many as several million such transfers each year. These costs, in one way or another, will ultimately fall on members and reduce overall pension saving.

The remainder of this response sets out our view of the key issues relating to this policy in more detail.

## Defaulting transfers

### Impact on members

The risk with any defaulted transfer, where the member's active consent is not required, is the risk of members being disadvantaged through transferring to a less appropriate scheme.

We note that the Pensions Act 2008 already establishes the idea of a 'qualifying' pension scheme for automatic enrolment. We also note that automatic enrolment itself uses the idea of an 'opt-out' instead of an active 'opt-in' similar to what is being proposed for transfers. But we believe that the considerations around defaulting someone into pension saving and defaulting them into a transfer are different.

These differences suggest that the definition of 'appropriate' with respect to transfers should perhaps be stronger than that for a qualifying scheme. In an automatic enrolment scheme, the member stands to benefit from an employer contribution and tax relief in addition to his or her own contributions.

There's good reason to believe that overall, these additional contributions mean that approach is a good deal for the member, irrespective of most other considerations. Indeed this was a key consideration for the Government in arriving at the policy of automatic enrolment in the first place.

In the case of a transfer, where those matching contributions have already been made, it's more clearly a question of comparison between schemes for where the 'better option' lies for the consumer. The risk of detriment relative to the alternatives could therefore be higher and is also likely to be more obvious to the consumer.

## Managing risks to the member

There are a number of options for managing these risks.

First, we believe there's an argument that such risks are less prevalent in relation to smaller pots because:

- the impact of any detriment will be smaller
- there's a clear offsetting overall benefit to savers due to the driving out of cost from the system and the economies this ought to produce.

Beyond this, for those small pots where a default might be appropriate, we would suggest that further protections could be put in place in the form of a defined set of standards for importing schemes to adhere to. Clear and robust standards could help maintain consumer confidence and help to minimise consumer risk.

Such a framework would clearly be for the Government to define and would of course need to take account of the impact of regulation and the costs of ensuring compliance.

However, areas where requirements could be considered include:

- member charges – any management charges paid by the member in the new scheme
- transfer charges – any charges levied on members to cover the administrative cost of the transfer transaction
- investment approach – the approach taken to the default fund into which transferred accounts are placed
- governance – the standards to which providers of receiving schemes are held
- member communication – disclosure requirements around the information transferred members should receive.

## Determining the size of a transfer

Determining the size of a default transfer is key to addressing the issue of simplifying administration for providers, and is a question that has attracted much comment. We note the implication that some level of transfer might need to be defined, beneath which a defaulted transfer would be allowed or possibly even required.

As set out above, we believe there are arguments for restricting defaulted transfers without the active consent of the member to cases where the size of the pot is causing inefficiencies in the system. Consistent with this, we believe it may not be necessary for such a level to be defined in legislation.

A simpler solution, discussed in more detail later in the paper, could be to create a 'right' for schemes to choose to push a transfer where the employment to which the pension was linked no longer exists. Such an approach would be efficient in the sense that all and only those pots that were uneconomic for schemes and providers would be moved. It would also give providers an incentive to reduce the costs of executing a transfer. This would be no worse for the consumer than the potentially arbitrary assignation of a limit beneath which funds can or must be transferred.

## Costs of administering a transfer

We agree with the Government that this is a major issue to be resolved under any discussion of default transfers. In the post-automatic enrolment world, most people are expected to be saving for a pension. In an economy where the average number of job moves in a lifetime is 11, or much higher in many cases, there's potential for any approach aimed at consolidating pension savings to create up to several million new transactions each year.

**Keeping costs low**

Part of the challenge in any model that allows existing schemes to reduce costs by defaulting away small pots is to ensure the incentive structure is set up to drive down the costs of executing those transfers. The framework of rights, responsibilities and requirements set up around transfers can help to create these incentives.

There may also be a case for setting requirements to apply to the transfer transaction to reduce costs. Possible requirements are set out below. Once again, these are intended as suggestions and there may well be other requirements that others would consider important.

- No member input – requiring transfers to be able to operate without input from the member while retaining the member's right to specify preferences if they wish, would make the transfer process much simpler.
- Ensuring funds to be transferred are unencumbered. This would mean more complex features such as an earmarking order or preferential terms such as guaranteed annuity rates could stop a transfer going ahead. It may also make it more complicated for any new regulations to apply to transfers out of defined benefit (DB) schemes.
- Making the act of transfer final and binding. This would mean, for example, that a transferring scheme had no call on the funds that it has transferred in the event that it transferred too much money.
- Requiring minimal and accurate information. For example, regulations could specify a similar information set to that required for automatic enrolment, together with information to allow the fund to be tracked back to the transferring scheme. This would allow the receiving scheme to reject the transfer until any problems with incorrect or incomplete data had been rectified. It would also help manage cost and give schemes an incentive to get data right first time.

As set out above, the requirements suggested here and in the managing risks to the member section are examples of issues that might fall under the categories 'requirements on receiving schemes' and 'requirements on the transfer process'.

There may be other such requirements and some of these may prove unnecessary. However, we believe the core concept of defining requirements in these areas could help to minimise risk and cost to the consumer and should form part of the consideration around any transfer policy change.

**Allocating cost**

The other question that follows from the issue of cost and is asked in the consultation document is 'who should bear those costs?'

We believe there's a case that, in principle, the transferring scheme should meet all or a significant proportion of the cost of the transaction. This is because it's the pushing scheme that derives the immediate economic benefit of removing a loss-making account. It's common practice at the moment for a scheme to incur a cost of making a refund under Short Service Refund rules, so requiring the transferring scheme to pay would not represent a new cost burden in that sense. Schemes could also factor this cost into the decision as to whether or not to push a transfer in the first place.

Whether or not it makes sense in practice for the pushing scheme to bear all of the costs depends to an extent on the model within which the question is being asked. Later in this response we go on to discuss some of the issues around 'pot follows the member' and aggregator models. In the former, requiring the transferring scheme to meet all of the costs may not make sense because of the role the receiving scheme plays in determining what that cost would be. In this model, it may make more sense to allow each scheme to meet their own costs.

In an aggregator model, the logic of requiring the transferring scheme to pay is stronger. In a single aggregator model, the cost burden on that aggregator of being a party to all of the transfers would be significant and in the end would have to be passed through to that scheme's members.

In a multiple-aggregator model, the combination of a choice of aggregators with the costs falling to the transferring scheme should help to drive competition and greater efficiency in the market for aggregation. In either model, assuming an aggregator model came with some form of Public Service Obligation (PSO) on at least one aggregator, the issue arises of how the residual cost of that PSO should be met.

On any model where the frictional costs are met by one or both of the schemes involved, these costs are all likely to be passed through to savers in some way in the end. Because of this, there may also be a case for allowing some direct charges on the transferred member. However, given some of the questions raised elsewhere in this paper about defaulting transfers, we believe any such charge may need to be capped. Allowing charges of this type would also fall particularly heavily on those moving jobs frequently. Steps may be necessary to ensure that those savers don't see too great an erosion of their savings over time as a result.

## Pot follows the member

We support the Minister's aspiration for savers to reach retirement with 'one big fat pot'.

However, we believe there would be potential risks and costs created if such an aspiration were delivered through an automatic or defaulted 'pot follows member' model without active member consent. These are the specific questions we would highlight around such a model.

- How to manage the risk of member detriment from being transferred to a less appropriate scheme? These risks are potentially greater in a 'pot follows member' model if literally all job moves are accompanied by a transfer of pension savings, irrespective of pot size. Allowing very large pots to be defaulted away may magnify the impact of any detriment and raises questions around the value of scheme-specific rules such as guaranteed annuity rates.
- How to manage the cost of allowing or requiring the defaulted transfer of all pots, which would require as many transactions as there are job moves each year, amounting to several million transactions? This could magnify the issue of frictional cost and could undermine any benefits from driving out the costs associated with the management of small pots.
- Whether it would be plausible to require all schemes to adhere to the standards that might be necessary for acceptance of a transferred pot? This could represent a significant regulatory intervention and as such could drive significant cost.

- What to do about the complex nature of employment status? For example:
  - where does a default transfer go when an individual has multiple employments that the transfer could follow?
  - what happens when someone moves from employment to unemployment?
  - what's transferred if two employers are paying to the same arrangement and the individual leaves one of those jobs?

For these reasons, we're unsure that the benefits of a 'pot follows member' approach currently outweigh the risks and costs.

## Aggregator solutions

We also believe there are questions and issues that would need to be resolved for an aggregator model to work, many of which are highlighted in the consultation document.

### One aggregator or many?

We believe that there are some potential risks around a single designated aggregator scheme because of the absence of competition that this would leave. This could give rise to a need for greater regulation around prices and service standards.

At the same time, we recognise the challenge that multiple aggregators, while potentially solving the challenge of giving schemes somewhere to send small pots, do so at the expense of the consolidation benefits for members that such an approach would seek to provide. From a consumer perspective, there are clear arguments that the benefits will be greatest with fewer aggregators rather than more. A multiple aggregator model also adds further complexity to the market which can again act against the member interest.

On balance, we believe the latter consideration outweighs the former and that in practice, one or a very small number of aggregators probably represents the best model for this approach.

The consultation document specifically considers whether NEST could operate as such an aggregator. This is discussed in more detail in a later section.

### A front-end clearing house?

An aggregator approach doesn't seem to us to require the introduction of a standardised front-end clearing house - irrespective of the number of aggregators. Such an approach could potentially introduce significant time and cost implications ahead of any solution being established.

We would also note that at several points in the past, clearing house solutions have been advocated as a part of the solution to a pensions challenge. This occurred at the time stakeholder pensions were proposed and again as part of the model choice debate around how personal accounts, now NEST, should be delivered. On each occasion such an approach has been rejected due to its complexity, a lack of appetite to fund it and an unclear case for the benefits it would deliver to consumers.

We believe that the necessary standardisation could be achieved through the designation of required data and processes to support a transfer. Providers of transfer platforms already exist within the market so some commonality already exists around data protocols. The information gathering requirements for qualifying schemes under the automatic enrolment regulations will further drive towards commonality of data.

### Other aggregator issues

Ultimately, whichever way an aggregator approach was structured, whether with a single aggregator or multiple aggregators, with or without a front-end clearing house, there are a number of further issues that need to be addressed.

- The need to ensure that individuals know or can easily find out where their funds have been transferred to. This is another benefit of one or a smaller number of aggregators.
- That the person responsible for selecting an aggregator scheme must make such a decision in the best interest of the individuals being transferred or at the very least, that there should be no financial advantage to the transferor in selecting 'scheme A' over 'scheme B'.

## A role for NEST?

Elsewhere in this response we've discussed some of the issues relating to the defaulting of transfers and different models within which such transfers might take place. Within the concept of an aggregator scheme, the consultation document and the comments of a number of organisations in response have highlighted the role NEST could play as an/the aggregator scheme.

We note the view of some commentators that there may be some natural common ground between the policy intent of this consultation and an extended role for NEST as an aggregator of small pots. It's likely that any model, pot follows member or aggregator, which seeks to enable better consolidation will require the creation of some sort of Public Service Obligation on at least one scheme to accept any transfers. Otherwise, schemes and individuals seeking to transfer much smaller pots may be unable to find a willing taker.

Individuals moving out of the labour force would also be unable to aggregate their funds easily and the schemes they leave would have to administer the fund they left behind. NEST already operates under a PSO having been established by the Government to deliver an automatic enrolment scheme for any employer looking to use it to meet their duties.

We believe that NEST could operate in such a role, although to do so would need something like the framework described in the costs for administrating a transfer section to be in place to minimise cost and complexity. Our overall desire would be for the transfer transaction to look and feel as much like an 'automatic enrolment' event as possible.

We would note, though, that the nature of an aggregation role is such that the pots being transferred would be small. In many cases they would be a few hundred pounds only, and would rarely come with any ongoing contributions, at least in the first instance, from the member in question. For any provider of such an aggregator model, where they are under an obligation to accept any transfer, this creates significant potential cost which it would be unlikely could be recovered within an acceptable charging framework from the members in question.

If NEST were to take on such a role we believe it would be essential to ensure that the existing members of NEST, brought in through its primary function as a scheme provider into which employers can enrol their workers, should not be asked to bear these additional costs. How best to achieve this would be a matter for the Government once it was clear on the policy direction it wished to take.

## Conclusions - a possible solution?

In earlier sections of this document we've set out:

- the importance of early progress in resolving the issues set out in the consultation document
- some questions around the challenges created by a model using default transfers of pots except in specific cases, notably where there are cost benefits within the system to allowing such transfers
- some questions and issues around the viability of a 'pot follows member' model
- thoughts on some of the key issues around an aggregator scheme, notably the trade-offs between one or many aggregators and possible benefits of tendering for a single aggregator
- the lack of a case in our eyes for a clearing house component to the model.

Taking these things together, we believe that this opens up the further question of whether there are steps that could be taken now which move us towards the 'one big fat pot' aspiration in the nearer-term without overly restricting the scope for more fundamental change later.

Many such 'interim' options may well exist and we would anticipate a number being proposed in response to this consultation. We would support any model that advanced the policy aims of the consultation while protecting the interests of the consumer.

One simple, incremental solution that we believe meets the Government's various objectives would be based around the idea of 'two rights and a responsibility'.

- The right for any registered pension scheme to choose to transfer away any pot that meets certain conditions. Those conditions would principally be to ensure the member in question had left the employment to which that pot was related.
- The right for any member, at any time, to request a transfer out of one registered pension scheme into another, including choosing an alternative destination scheme if their current scheme instigates a 'push'.

These two conditions would ensure schemes didn't have to bear the ongoing administrative costs of looking after small pots with no possibility of further contributions coming in. They would also ensure the consumer retained the ultimate say in where their money went.

The responsibility would be placed on at least, and perhaps only, one scheme, meeting certain quality conditions, to accept any transfer instigated by another scheme. This could be NEST, provided the considerations set out in the previous section were met.

**A step towards a better model**

We believe that this approach:

- would provide an easement to offset the removal of SSRs in the form of the right to push transfers without the member's consent
- could be implemented quickly – the critical path would probably be determined by the need for primary legislation
- would make a significant step towards enabling greater consolidation for the member.

Such an approach would establish a much greater precedent for the transfer of members' funds and would start to build towards a smaller number of larger pots.