Work and Pensions Select Committee Inquiry into governance and best practice in workplace pension provision

Introduction

1. With the advent of automatic enrolment, questions of governance and best practice in workplace pension schemes become ever more important. Automatic enrolment will transform pension saving in the UK and most new saving is likely to be delivered via defined contribution (DC) schemes. It's vital that DC schemes deliver good outcomes both for the millions of people already saving in them and the millions of people who will start saving for the first time under automatic enrolment.
2. NEST's[1] investment approach is designed to minimise the possibility of losses while providing realistic and sustainable investment growth. Our target for NEST Retirement Date Funds is to exceed inflation after all charges. Our analysis shows that nearly 80 per cent of modelled scenarios using just a static strategic asset allocation deliver investment growth of more than 3 per cent after allowing for inflation and management fees. With traditional lifestyling approaches, the chances of achieving that are significantly less.
3. NEST brings innovation to many areas of pensions, for example in our communications with members and our investment approach. We've given a great deal of thought to other areas of focus for this inquiry, such as how to make use of economies of scale and we're keen to share this experience. However NEST would like to stress that many of the issues addressed by this inquiry are complex and highly technical. Given this and the constraints on the length of the submission we've given some headline thoughts and have largely focused our remarks on what NEST is doing.
4. Our remarks are also made from the perspective that this is the beginning of our journey. We're confident that our research and preparation has resulted in a pension scheme that will serve our membership well. However in the longer term, our governance structures and culture will need to evolve and develop with the demands of our diverse membership and in line with new insights from best practice.
5. This paper addresses each area of the inquiry in turn. Please note that we haven't answered the last question on the outlook for defined benefit schemes as this isn't our area of expertise.

[1] In this submission, we use the term 'NEST' to refer both to the scheme and to NEST Corporation, the trustee of NEST, depending on the context.

Transparency of charges and costs

6. Our members pay a 0.3 per cent annual management charge (AMC) on their retirement pot. There's also a 1.8 per cent contribution charge deducted from contributions before they're invested. These charges apply to all our fund choices and there's no additional charge for switching between funds. They're especially beneficial to people whose savings are intermittent as there are no additional charges for inactive members.
7. NEST's charges cover all custodian, accounting and legal costs, which isn't always the case with other schemes. As with other pension and investment funds, our members will face additional costs associated with buying and selling investments that are deducted from performance. However the impact for NEST's members of these is proportionately very small, as NEST is a long-term investor so we invest largely passively, which has a lower cost than active management. In addition, the way our mandates are set up has effectively created our own internal market, which allows us to re-balance our funds without buying and selling units on external markets, saving significantly on dealing costs.
8. As well as being clear what our charges are and what they cover, transparency also demands that we're confident our members understand what they're being charged. Our member communications use worked examples and illustrations to help members understand, in pounds and pence, the level of charges they may pay. Examples of this approach are shown below. The first graphic shows the contribution charge on a £50 contribution, the second graphic shows the annual management charge on a pot of £5000.

9. We're working with the National Association of Pension Funds (NAPF) initiative on transparent charges and NEST, along with other low-cost schemes, has changed the debate as to how charge levels are viewed in the pensions industry.

Clarity of communication to pension scheme members

10. Members need to understand how their scheme works and what their options are if they're to exercise choice, or consider exercising choice, effectively.
11. Existing pensions jargon and communications are a huge turn off for many savers, particularly those in the lower and middle income groups. Research has shown that only 15 per cent of potential savers in NEST find the language used to describe pensions straightforward and easy to understand. Almost 60 per cent say pensions seem so complicated they can't understand their best options.[2]

[2] Information from NEST/YouGov online survey conducted between 3 and 5 January 2012. 1,985 GB adults were interviewed and results are weighted to be representative of the adult population. Of those interviewed, 245 (weighted) were identified as eligible for automatic enrolment and with no pension savings and therefore in NEST's target group.

12. To this end we've developed a phrasebook that provides easy-to-understand alternatives to pension jargon. We also use a 'three-tier' approach to organising our information. This means our communications can cater for casual readers who can quickly access the top-level facts about NEST and their own pot, as well as those who want more detailed information. All our communications are subject to ongoing testing using research panels, customer feedback and user testing to make sure they continue to aid understanding.

The government's proposals for managing small pension pots (and the related issue of short-service refunds)

13. NEST responded to the government consultation, and this response is available here: **http://www.nestpensions.org.uk/future-challenges**
14. To summarise our view, we believe a meaningful step towards the Government's stated objectives that's consistent with further and more fundamental change could be taken quickly.
15. 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.
16. This would provide the basis for greater aggregation now, in ways that support more all-encompassing models for consolidation later.

How DC scheme members can be supported to make investment decisions and assess risks, including when converting to annuities

17. An important finding in our research into the attitudes and behaviour of savers is that most investors won't make any decisions regarding their investment. For this reason it's vital to have a default option that delivers a good result for most people most of the time.
18. Our own default approach, based on a series of 47 yearly target date funds called NEST Retirement Date Funds, is based on extensive research into what our target market wants and what they need. We believe that this, along with the three phases of investment, targeted at managing capital protection, inflation and conversion risks, offers a significant improvement on the options available to this market from traditional pension schemes.

Investment decisions

19. We expect most of our members to default into the NEST Retirement Date Fund that matches their expected retirement date or State Pension age. For members who want to make an investment fund choice, perhaps because of their beliefs or different appetites for investment risk, we have a selection of other funds.
20. The five choices – which include the NEST Higher Risk, Ethical Fund and Sharia Fund – represent a

deliberately focused range compared with many other DC schemes. They reflect the diversity of our expected membership, but there aren't so many that members will be confused or conclude that they ought to be making an investment decision. This could be the case where there are dozens, and sometimes hundreds, of options.

21. When a member is considering switching funds, we provide clear information on the alternatives and health warnings on the implications of switching. We're committed to ongoing research into improving the ways in which we talk about investment to help us with our aim of achieving good outcomes for those who want NEST to make decisions on their behalf and those who want to get more involved.

Buying a retirement income

22. As members approach the date they intend to take their money out of NEST, we'll contact them to help them understand what's happening to their pot and to make them aware of their options.

23. When the time comes to buy their retirement income, members will have access to our Retirement Panel, where they can request quotes and check on what sort of income they could get with their pot. Uniquely our panel will allow members who have pots of just £1,500 to convert them into an income for life. They'll also be able to explore the open market option and shop around for a retirement income on the open market.

Managing investment risk and security of returns

24. NEST's investment horizons are aligned with our members, which for many are necessarily long term. We aim to ensure members can take full advantage of market growth while reducing the possibility of significant falls in their pot, particularly just before they retire.

25. Capital protection risk, inflation risk and conversion risk are our focus. NEST's Investment Team manages these risks throughout a member's saving lifetime, rather than adopting a mechanical 'set and forget' approach that could result in their money being invested unsuitably for decades.

NEST Retirement Date Funds

26. The overarching investment objective is to grow pots well in excess of inflation after all charges. This keeps both NEST and our members focused on actual outcomes, not standalone or relative investment return figures that don't take account of the impact of charges and inflation and may create unrealistic expectations. Our members aren't interested in outperforming an index if that outperformance results in getting less than they've put in.

27. Younger members could spend more than 40 years investing in a NEST Retirement Date Fund. Over that time their fund will go through three phases:

Foundation Phase – managing capital protection risk

28. Our research indicates that younger members could stop saving if they see falls in the value of their savings. For this reason, members joining in their 20s will spend up to five years in the Foundation phase. Their pot is fairly evenly split between growth assets and capital-protection assets to target real returns after charges, while managing downside risk. Our modelling tells us that the impact of the Foundation phase on final pot sizes is marginal.

Growth phase – managing inflation risk

29. In the Growth phase we target 3 per cent growth above inflation after all charges by investing in a higher proportion of return-seeking assets, within our given risk limits. Their pot is invested in a well-diversified portfolio, where risk is monitored and managed dynamically by our in-house investment professionals. Members could spend up to 30 years in this phase.

Consolidation phase – managing conversion risk

30. The Consolidation phase starts around 10 years before retirement. We gradually move members' pots into assets that broadly reflect the way we expect them to take their money out of NEST. We expect to grow each pot by more than the cost of living during this phase, but our primary focus is securing the member's retirement income and protecting their pot from sharp falls in equities and other growth assets.

Security of returns – NEST analysis of probability

31. We conduct extensive modelling and stress testing of our approach to ensure that it's likely to achieve what we set out to do. Our analysis shows that nearly 80 per cent of modelled scenarios using just a static strategic asset allocation deliver investment growth of more than 3 per cent after allowing for inflation and management fees.

32. This analysis also shows that it's very unlikely that a member's final retirement pot will be less than their contributions. This is very different from other strategies available to UK savers, which tend to focus on single asset classes or don't take account of whether the investment is suitable to the economic environment or market regime. These result in a wide spread of outcomes depending on when people save and when they retire, creating a pensions birth-date lottery. Our holistic approach to managing risk throughout a lifetime of saving delivers a more balanced return for all members.

Managing investment risk – Investment beliefs

33. The Trustee has established a set of guiding principles to provide an objective and transparent framework for consistent investment decisions and to support all investment functions. These principles include well-evidenced concepts such as:

- diversification is the key tool for managing risk and return
- risk-derived asset allocation is the biggest determinant of long-term performance
- analysis of both economic conditions and market regimes should be used to drive strategic decisions.

34. Allowing our members and stakeholders to see why investment decisions are made and how we operate helps build trust and increases the chances of the Trustee making good investment decisions consistently.

Whether greater economies of scale within the sector could produce better value for money for members and if so, how this can be achieved

35. NEST believes that scale can deliver lower costs but in order to achieve this, products must be designed to this end. NEST has been designed from the outset to capture scale economies in order to build an easy-to-use, low-cost e-pension, focussed on the needs of low to moderate earners and their employers.

36. The vast majority of NEST processes have been designed to be completed by users themselves with 'straight through processing' of transactions, which achieves low costs and a high-quality process. Given our scale large amounts of day-to-day casework would be too much of a cost burden for our Trustee Members. NEST's Trustee Members are therefore setting standards and rules that will enable the majority of cases to be processed efficiently, reducing bespoke casework to manageable levels. As NEST grows in size we'll keep these standards and processes under review to ensure they're appropriate and add to the smooth running of a high-quality pension scheme.

37. NEST believes that scale can in many cases deliver lower costs to members where products are designed to achieve this. In such cases we believe that the advantages of spreading fixed costs, a stronger position when undertaking procurements and the opportunity for greater specialisation and automation, can deliver significant benefits to members. Equally there'll be circumstances where savers' needs can be well served by a smaller scheme, particularly where there are specific needs. Smaller schemes can also use outsourcing of scheme administration and other activities to access some of the scale economies available directly to larger schemes.

How to strike an appropriate balance between regulation, self-regulation and good governance which restores confidence and raises standards

38. As we're run as a trust-based scheme, there's a direct relationship between the interests of our members and the decisions made on their behalf. In addition, we have a Member Panel and an Employer Panel as required to be created by statute. These report to the Trustee through the Chair and provide a formal route to address the views of the users of the scheme.

39. NEST Corporation is the Trustee of the scheme. It has a number of legal duties including a fiduciary duty to act in the interests of scheme members. The Trustee currently has a Chair and ten other Trustee Members. The Trustee Members are supported by an Executive Team led by the Chief Executive Officer (CEO) Tim Jones, who is also the Accounting Officer for NEST Corporation.

40. Trustee Members set the strategic direction and objectives for NEST, overseeing the running of NEST to ensure it delivers value for scheme members' money. As well as full meetings of Trustee Members, there are five supporting Trustee Member committees.

41. Within the context of being run as a trust-based scheme, NEST notes with interest that a wider debate concerning the interpretation of fiduciary duties is developing. Fiduciary duties for trust-based schemes are a product of the case law that makes up Common Law. It's an evolving body of law that reflects the times. In relation to pensions, it's increasingly debated as to whether the fiduciary duty to act in members' interests means more than just their narrow financial interests expressed in short-term, predicted investment returns. For example, should these interests also include keeping members investing,

ensuring that communications are meaningful, providing lower charges, developing suitable default funds and considering the longer-term impact of investments on society and the environment when delivering risk-adjusted investment returns?

42. These considerations recognise that there's more to delivering a good result for members than just a one-dimensional focus on investment returns. Consideration should be given as to how fiduciary duties must evolve within this debate and changing social norms.

43. It's also in NEST members' interests that the companies we invest in are well governed and likely to produce sustainable and stable growth for decades to come. This is why NEST takes its ownership rights seriously.

44. NEST has signed the Financial Reporting Council's UK Stewardship Code and is a signatory to the United Nations-backed Principles for Responsible Investment (UNPRI).

45. More widely, retirement savings vehicles in the UK currently have two regulators, The Pensions Regulator (TPR) and the Financial Services Authority (FSA) with the FSA soon to be split between the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). This increases the difficulty of getting consistent regulatory approaches.

46. We agree with the current approach to governance by TPR of 'comply or explain' rather than prescriptive legislation. TPR should continue to focus on member outcomes, record keeping and employer compliance rather than inputs or processes.

47. In the future, the EU and the European Insurance and Occupational Pensions Authority (EIOPA) look set to take an increasing interest in occupational pensions and corporate governance. For example, the recent EIOPA consultation on the revision of the Institutions for Occupational Retirement Provision (IORP) Directive included a proposal for DC IORPs to hold capital against operational risk. This proposal hasn't been defined in detail at this stage, but it could push up the costs for members. Finding the right balance between consumer protection and consumer costs needs constant monitoring.

The scope for collective DC schemes and other risk-sharing schemes

48. While NEST recognises the potential benefits of risk sharing approaches we believe that well-designed DC schemes can deliver many of the features that make prospective risk-sharing arrangements attractive. In particular good DC schemes can deliver more certain outcomes for members and deliver similar outcomes across cohorts, so reducing the chances of particularly 'lucky' or 'unlucky' years to save and retire.

49. We also believe that by designing investment objectives and the assumptions used to show likely outcomes to reflect inflation, charges and other factors that represent realistic – as opposed to optimistic - scenarios, DC schemes can deliver outcomes more in line with member expectations as they grow their pots.