Reshaping workplace pensions for future generations

Consultation response

Introduction

NEST welcomes the government's consultation on 'reshaping workplace pensions for future generations'. Alongside the recent consultation on improving quality standards in DC provision these initiatives represent timely interventions for improving the quality of pension provision for millions of new automatic enrolment savers. NEST particularly welcomes the focus on consumer experience that both the quality standards and reshaping workplace pensions' consultations have placed at the heart of their proposals. In our view traditional approaches to defined contribution saving may not have addressed member needs or expectations particularly well in the past. Employers have been placed in an uncomfortable situation of either offering DB schemes where they may be concerned about their own balance sheet liabilities, or DC schemes where their workforce may be exposed to uncomfortable levels of income uncertainty, short term investment volatility and lower levels of additional benefits, such as ill-health pension entitlements and partner and family benefits payable in the event of early death.

The framework for defined ambition schemes provides an opportunity for increased innovation and the development of pension products, investment strategies and administrative frameworks focused on member needs and expectations. Providing plurality of provision for employers could prove a significant step forward and a move away from the somewhat tired debate about the relative merits of pure DB versus pure DC. The creation of a mass market through automatic enrolment offers a real opportunity to develop an improved regulatory regime for pension schemes that is forward-looking rather than attempting to deal with the problems of the past and we applaud the Government's boldness for asking difficult questions. These questions will require similar courage on the part of providers, employers and their advisors to continue to develop long-term savings solutions suitable for the 21st century.

Our response to the specific questions where we believe we can offer some insight are set out in annex A. We haven't commented on questions 4 – 24 in relation to DB and have instead restricted our comments to proposals covering different approaches to providing greater certainty for members in the defined contribution world. NEST intends to publish its latest member research findings into consumer appetite for greater certainty early in 2014. This response draws heavily on our considerable evidence base of the target market for automatic enrolment.

In summary, before answering the specific questions we'd like to make the following general points:

- First, we believe the premise of providing a more simplified regulatory regime which encourages quality and innovative occupational provision for thousands of employers and their workforces is the right one. We think the existing division between DB and DC is unhelpful. Recasting occupational provision on a spectrum between these traditional models is more appropriate for the modern UK labour market. The focus should stop being on whether DB or DC is more suitable but instead be on better governance and higher quality, whatever type of scheme an employer uses.

- Secondly, when considering provision where the employer has responsibility for only making contributions, understanding consumer needs and concerns – even when they may appear irrational from a rational economic perspective – is the right one. Automatic enrolment is predicated on the powerful lessons of behavioural economics. It has already proven successful in its initial stages with two million enrolled and encouragingly low levels of opt-out. A general concern however, is whether this success continues when contribution levels increase and when over time individuals start to engage more with how their savings are being managed. It would seem odd that the lessons learnt about how real people view saving for the future taken from behavioural economics when creating automatic enrolment, are not carried into the design of the savings' vehicles created to deliver on it. It's our belief that an overreliance on the powerful and undoubted benefits of inertia could store up significant challenges in the future, particularly when savers need to engage about saving adequacy and how they plan to convert their savings into incomes in retirement.
- Thirdly, when dealing with long term investment horizons and attempting to provide certainty decades into the future, the financial services industry and policy makers should approach the challenge with humility. The events of 2007 and beyond show that the unexpected can and will happen despite the sophistication of financial modellers and analysts. Black swan events such as the global financial crisis can lay low even the largest of financial providers and predicting the future with certainty is impossible. NEST has conducted extensive - and we believe ground-breaking research - into the automatic enrolment target group's needs and wants. We've identified that the desire for greater certainty is near universal and deeply held. However, equally felt is scepticism towards financial service providers and even government when it comes to promising future benefits. We've been continually surprised at how often the names of Maxwell and Equitable Life have surfaced in discussions with potential members, when few if any were directly affected and how deeply damaging promises made and not delivered can be to confidence for saving for the future. A lack of confidence in the savings system as a whole could prove as damaging to automatic enrolment as a lack of confidence due to defined contribution schemes providing no guarantee of future outcomes.
- Fourthly, NEST was created by statute as a defined contribution scheme. As such, all our efforts to date have been aimed at designing an investment approach and communications that meet consumer needs and expectations within the defined contribution legislative framework and the requirement to operate within a low-cost charging structure. We believe we've created an innovative approach to long-term saving based on sound investment principles, that also goes some distance to meeting the concerns of savers about things like shorter term volatility, the possibility of loss and the uncertainty of outcomes savers can expect. However, if the legislative framework for occupational schemes changes, the Trustee of NEST would be interested in working with government and the industry to further evolve our approach to meet some of the consumer challenges that all pure-DC schemes are likely to continue to face. The recurring message from much of our member research is the need for DC schemes to answer the following simple questions that savers ask.
  - What will I get at the end?
  - What happens to my money when it's in the scheme ('where does my money go?')?
  - How safe is my money?

While operating within a pure DC framework we believe it's unlikely that any DC scheme can satisfactorily answer these questions in a way that fully meets consumer expectations. We have however, found that there are better ways to communicate with savers, that go some way to alleviating their concerns and we've begun to incorporate these findings within our own messaging and member communications. It's also true that as pension saving becomes the new norm, attitudes, understanding and confidence is likely to improve over time. People may well learn to be more comfortable with uncertainty, or at the very least not take potentially detrimental action such as ceasing contributing, or being discouraged from making additional contributions because of the uncertainty inherent in pure DC saving. However if there are additional elements that could be incorporated within a new framework for occupational savings; that give schemes the opportunity to provide better answers to the questions above; and if they can be incorporated at reasonable cost; without over-promising - then NEST may well wish to take the opportunity of further evolving our approach if we believe to do so would be in the best interests of our members.

We're therefore pleased that the concept of defined ambition isn't a single, one-size-fits-all approach, but allows for the development of a variety of solutions that can be incorporated in a variety of ways. We're particularly interested by the consultation's proposals that suggest different solutions may well be appropriate for different phases of saving throughout an individual's lifecycle. This fits well with NEST's current approach because we agree with the thrust of the proposals that there shouldn't be a single way of creating more certainty, or that the same level or type of certainty is appropriate for savers in their 20s, 30s, 60s and beyond.

We're particularly pleased to see that new approaches under consideration are aimed at providing greater certainty for incomes in retirement rather than on nominal pot sizes or short term capital preservation. The desire to create innovative solutions up to and into retirement is an area that NEST intends to do further work on in its own investment approach.

- Finally, NEST intends to publish its latest member research findings into consumer appetite for greater certainty early in 2014. The research report covers:
  - appetites for guarantees
  - whether savers are able to trade off different DC features of certainty, expected outcome and charges
  - whether guarantees would be bought at any cost
  - how guarantees affect an individual's likelihood for saving more
  - the potential benefits of probabilistic rather than deterministic projections of member outcomes.

We think this is the first research to specifically attempt to investigate consumer appetite to trade-off different features of defined contribution schemes' investment approaches, and we believe the results are instructive in the design and development of future DC style products.

While the research supports the hypothesis that greater certainty and products positioned as having a 'guarantee' are superficially attractive, what's most striking are the survey's findings regarding savers' expectations of pensions in general. Throughout a number of research projects we've been confronted with real saver confusion about the purpose of pensions and the need to take any investment risk, or other risks, at all.

First, participants are surprised to find that their money is invested in things like the stock market, debt instruments or real estate. Secondly, they don't appreciate the rationale for why this is required, for example to deal with the corrosive effects of inflation over the longer term. Taking investment risk with their retirement savings appears counterintuitive to them. The concept of having to pay extra for a 'guarantee' seemed shocking to most who took part in our research. Pensions are presumed to be guaranteed already and there's a significant amount of surprise that a retirement savings vehicle doesn't inherently offer, at a minimum, protection of contributed capital.

When research participants were taken through the specific attributes of different approaches in more detail, the initial preference for a product that offered least chance of loss proved much less popular both in terms of charges and reduced potential for reasonable outcomes. That isn't to say that given more information savers are more likely to embrace risky products. In fact, the research - perhaps alarmingly for policymakers and the pensions industry – suggested that traditional DC products with very high equity allocations are the least favoured type of investment vehicle. This is precisely because of the degree of outcome uncertainty and potential risk, albeit small, of getting less at the end than the total contributed over 20 years of saving. When forced into trade-offs between cost, outcome and certainty, there remains a strong bias towards products that provide more consistency of outcomes, with low, though not the lowest, levels of risk of something 'catastrophic' happening.

The research also suggests that a greater degree of certainty of outcome and reduction of the potential for capital loss (a pot size lower than total contributions in nominal terms) would be conducive to savers making additional contributions. While we're always cautious about the degrees to which reported behaviour translates into actual behaviour, we believe it's not an unreasonable assumption to presuppose that attempts to encourage savers to make additional contributions beyond the minimum level in the future, will be easier where savers feel more secure about their existing saving.

About us

Employers in the UK now have a statutory duty to enrol some or all of their workers into a pension scheme that meets or exceeds certain legal standards. They're also likely to make minimum contributions for these workers.

NEST is a defined contribution pension scheme that UK employers can use to meet their new legal duties. NEST is an easy-to-use, low-charge scheme that has a public service obligation to accept employers of any size or sector that want to use it.[1]

NEST has a series of investment beliefs that guide the Trustee's approach to investing. The first of these beliefs is:

That understanding scheme member characteristics, circumstances and attitudes is essential to developing and maintaining an appropriate investment strategy.

NEST conducted an extensive research programme into its likely membership prior to setting its investment strategy, consisting of primary research into risk appetite, loss aversion, income breakdown, existing savings behaviour, work patterns, age profiles and outcome expectations. In addition we carried out further research into cultural drivers for saving within minority groups to assess what additional fund choice provision is required beyond the default fund.

This research led to a number of innovations that in our view make DC saving more suitable for NEST's target group. This group is, roughly speaking, drawn from 80 per cent of the working age population by income. Examples of these innovations are:

- investment return objectives based on generating real return, rather than focussing on traditional benchmarks, for example, FTSE 100
- a dynamic approach to risk management that incorporates significant diversification across asset classes, geography and sector
- yearly target date funds – to allow greater efficiency and flexibility in managing risk throughout a member's savings career
- phased approach to investing with different risk and return objectives for different stages of a savings career
- objectives designed to reduce the variability of outcomes for members retiring at different times
- an aim to ensure most members' savings will grow to substantially outpace inflation over the longer term and be well positioned to purchase a lifetime income in retirement[2]
- objectives aimed at mitigating the impact of catastrophic market loss.

NEST continues to conduct research into the target group and increasingly into its actual membership, in order to ensure its approach to investment, delivery, counterparty security and communications remain in step with member needs and expectations.

[1] More information about NEST available at: nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/key-facts-myths,PDF.pdf

[2] The growth that most members' experience will depend predominantly on what age they start saving. For members in their 20's our modelling suggests that if NEST's investment objectives are met, their total pot will consist of a third made up by contributions and tax relief, a third made up of growth keeping pace with inflation and a third being returns in excess of inflation. For members who start saving later in life the returns in excess of inflation are likely to be lower.

Annex A

1. Do you agree that a greater focus on providing members with more certainty about savings or preferably income in retirement may increase confidence in saving in a pension?

Yes. NEST's approach to date has been based on understanding members' needs. Everything we've seen from our research suggests that the majority of new savers value security of their saving and more certainty about outcomes over a strategy that looks to target achieving the highest potential returns but with considerable uncertainty. This has led NEST to develop a number of innovations in its approach to DC investing. Among these is our Foundation phase, which looks to build confidence in saving for our younger members by generating returns in excess of inflation while significantly reducing the impact of severe investment shocks.

We agree that certainty of income is much more relevant than certainty of savings and agree that that should be the focus of product design within any new regulatory environment. However, the potential for the appearance of capital to be lost – even when extremely remote and even when only in the short term - is something that remains an uncomfortable proposition for savers according to our research. Much of this fear stems from serious misconceptions about the nature of occupational pension saving and the rationale in savers' minds of why any investment risk should be taken at all. This fundamental mismatch between what savers expect and what pension products are designed to deliver is, in our view, a significant driver for wanting capital protection and other attempts to guarantee outcomes, built into a DC scheme.

2. As an employer, do you have experience of, or can you envisage any issues with, employees being unable to retire due to DC pension income levels or certainty about income levels?

We've heard employers express concerns that elements of their workforce will be unable to afford to retire because of fears about their likely level of income in retirement.

3. Do you have any further evidence or research planned that might help inform the development of DA pensions?

NEST has conducted a significant amount of research over the last four years, including research into guarantees and trade-offs between different DC product features conducted over the summer of 2013. This will be published in early 2014.

25. Do you think having more certainty than traditional DC would be welcomed by members, and help generate consumer confidence and persistency in saving?

As we set out in our response to quality standards in DC, we believe that DC schemes can already do a lot to meet the concerns of their members. NEST's approach of a diversified and actively risk managed approach to investing is aimed at delivering good outcomes consistently for most members and reducing levels of uncertainty of final outcomes, as well as the possibility of significant loss due to downside market volatility.

We believe this goes some distance to meeting consumer concerns. In addition NEST has undertaken a large amount of work aimed at finding better ways of communicating investment and why taking some risk when saving for the long term is a prudent course of action. Together this approach is in our view likely to be welcomed by members and improve consumer confidence.

Our latest research project looks at what individuals would trade off in terms of cost, final outcomes and certainty. When presented with illustrations of these parameters for NEST's current investment approach, a diversified and risk managed DC vehicle was seen as a more attractive (or less unattractive) option than an explicit money back guarantee, by a large proportion of savers. Having said that, a similarly large group would prefer an all 'cash' (very low-risk/low return strategy using money market instruments) approach. This indicates the significant lack of confidence in investing in anything beyond what's familiar or the benefits of products that use elements of financial engineering to compensate for what are perceived as risky and unsuitable long-term savings vehicles. We've found that participants in a number of NEST research projects equate pension saving as similar to saving in a bank or building society.

What was particularly striking from our research however, was how disliked the traditional approach to pure DC investing was for the majority of those taking part. A traditional DC growth phase approach invested primarily in equities was ranked in fourth place of four by nearly 60 per cent of respondents and in third or fourth place by three quarters of respondents. It was still ranked this low despite offering the possibility of significantly better outcomes - over £167,000 in the top decile of modelled outcomes versus £49,000 for the product offering the lowest expected outcome.

We therefore agree with the premise of the question, but would note the current legislative framework allows for a wide spectrum of DC approaches to be offered. We'd be concerned if all DC provision was lumped together and labelled as unsuitable. We believe that for the automatic enrolment market there's a wide spectrum of quality available at present as we set out in our response to the quality standards in workplace defined contribution schemes consultation. The question for a scheme with an investment approach like NEST is, would we want to give more weight to the clear preference for greater certainty that research participants indicate they want, potentially at the expense of some upside?

26. As an employer, if these products mean there is no funding liability, only the requirement to contribute as for a traditional DC scheme, would you be interested in offering these products to employees?

We haven't seen a great deal of appetite from employers to engage in discussions about greater certainty when it comes to investment approaches. Most employers in our experience are currently focussed on meeting their automatic enrolment duties. Investment approaches of different providers appear to be of second order interest. We suspect that may well change over time once automatic enrolment becomes more embedded.

27. In relation to medium- and long-term guarantees outlined in model 2 (capital and investment return guarantee), and model 3 (retirement income insurance), would removal of the legislative barriers be sufficient to stimulate the development of market-based solutions?

We think that greater simplification of the legislative framework could result in greater innovation and more willingness for providers and employers to consider looking at approaches to introduce greater certainty. The current legislative framework we believe gives cause for concern that exploring different approaches that involve more outcome certainty is likely to tip schemes into funded liability territory, or into more costly insurance based requirements involving significant solvency requirements or reserves.

NEST notes the proposals set out relating to longer-term illiquid investments such as infrastructure to provide stable longer-term returns – a good match in our view for DC schemes with a long investment horizon who have scale and are likely to be cash flow positive for decades. We think this could be a fruitful avenue for the government to explore further with the pensions industry. We note that this type of investment would likely result in savers being locked in to the scheme for certain durations. We suspect this is a trade-off that most savers would be willing to make.

As noted earlier we think the desire for the type and amount of greater certainty varies at different points of the savings lifecycle. Younger savers appear very nervous about capital protection, older savers are more focussed on certainty of retirement income. We particularly believe that models three and four, which look to give a greater deal of certainty of income as individuals near the end of their savings career will be of most interest to members. Model two looking at the protection of capital and investment returns we suspect would be of less value to most members.

Our research across all age groups has identified that it's less the specific issue of capital loss that causes most concern rather that capital loss appears random and unstoppable. Messages attached to retail investment and savings products such as 'your investments can go down as well as up, and are not guaranteed', were frequently cited across different NEST research projects and were considered as deeply off-putting, leading to an assumption that any investment probably would go down and continue to go down until reaching zero.

Our research suggests the tendency to 'catastrophise' loss rather than seeing loss of capital as likely to be small and temporary and assume downside volatility leads to total loss of contributions. The reality, even in the most extreme market situations we've seen recently, is that usually any well-diversified fund would be extremely unlikely to see losses of more than 40 per cent within any given period. For example the equity losses experienced in the dot com crash were of the magnitude of 40 per cent over that year. Within a few years these had largely been recovered, though the same can't be said for smaller technology stocks – many of which remain below the waterline.

Providing this short term loss isn't crystallised at retirement, in most scenarios funds would see rapid recovery. However the length and severity of these tail risks is always uncertain. The experience of Japanese equity markets in 1989 to the present day is one of a number of exceptions to the rule that markets generally recover quickly from shocks. So while finance experts may see a focus on short term loss as irrational, an inability to say how bad or for how long the effects of severe market conditions will be felt on an individual's pot does nothing to build confidence for long-term saving.

In essence this is the heart of the DA challenge. How can scheme design manage extreme downside tail risk in a more acceptable way than pure DC? Introducing floors to the amount values can fall and guarantees of a proportion of pot being 'banked' as a retirement income would - in our view - go a long way to improving confidence without needing to guarantee the whole pot for all of a saving's career. In addition, providing consumers with better explanations and reassurance that volatility is to be expected and on the whole necessary in generating better incomes in retirement will continue to be a challenge for all providers and policy makers that needs addressing. Our research suggests that this challenge shouldn't be underestimated.

The concept of 'banking' small parts of a guaranteed retirement income is an approach taken in the US already with products provided by TIAA-CREFF, where proportions of contributions are invested in the equivalent of deferred annuities throughout a savings career. In effect this ensures that whatever happens with other elements of investing, a proportion of retirement income is protected.

One concern we have about some of the models outlined in the consultation paper is the appearance of a need to guarantee the whole pot or whole series of contributions. We suspect smaller guarantees for retirement income starting in, for example, a member's forties or fifties, increasing as they approach retirement and beyond, would be the sort of approach that could fulfil the objectives of a defined ambition scheme. These would provide greater certainty without giving up the potential for significant fund growth and without attracting exorbitant charges.

28. ***As insufficient scale has been identified as a barrier to providing affordable guarantees, is there a role for the government in facilitating different types of pension vehicles that would create greater scale for this purpose?***

We agree that scale is likely to be a significant factor. New multi-employer master trusts seem to potentially offer part of the solution.

Other elements that could be a useful component in providing affordable guarantees are asset classes that provide generous low risk income streams at the expense of liquidity. We think that the government could play a useful role in the provision of DC friendly investment opportunities in things like infrastructure and other illiquid long-term investment opportunities such as forestry and agriculture.

One point that we want to raise regarding the relationship between scale and cost of guarantees is the assumption that scale makes guarantees more affordable. We think this is a false assumption as significant scale is likely to mean that counterparties' balance sheets are unable to bear the cost of standing behind such large liabilities. In general insurance, risks are spread across a range of uncorrelated risks for example, car insurance or buildings insurance, whereas in financial insurance the risks tend to be realized simultaneously, for example, markets tend to be highly correlated when they're falling and the insured all hold the market. An example would be the situation during the credit crunch where companies like AIG simply became overwhelmed by the call on the protection they'd sold. Arguably this would support our point that attempting to guarantee everything may prove to be both uneconomic and not available at any price. Whereas, focussing on specific pinch points in terms of consumer need for greater protection could allow greater innovation and participation from a higher number of counterparties, who may otherwise be put off by the amount of risk and duration of the risk they'd be required to take.

There is of course always the option for the government to be the lender of last resort to cover the extremities of extreme tail risk events, or to organise the market to collectivise the risk as has occurred through the FSCS and PPF. Again however, we'd point out the nature of financial insurance suggests that when things go wrong, they go wrong for everyone and put huge pressure on any insurance or compensation arrangements.

29. Are there any additional legislative barriers that stand in the way of innovation of products with guarantees?

Clarification as to how large schemes approach the bulk purchasing of retirement income products up to and into retirement would be beneficial. The market and the legislative regime in the US appear to allow for more innovation for blurring the line between saving and decumulation. A regulatory regime that encourages the development of more affordable deferred annuities and variable annuity type products based on true economic capital could greatly increase the scope for innovation in both the pure DC and future DA world.

We believe greater focus on this area would be a good fit with the wider government agenda of eroding the cliff edge of retirement and reducing the significant conversion risk faced by many UK savers in pure DC schemes. One of the biggest challenges to providing greater certainty of income in retirement, rather than aiming for just the biggest final pot, is the one-off nature of annuity purchase and the widely divergent outcomes similar pot sizes can achieve merely on the basis of conversion timing. Spreading this risk over a number of years, or as TIAA-CREFF and ATP do - over a lifetime, could potentially provide a lot more consumer comfort of the benefits of longer-term saving and encourage higher contributions and greater persistency. Furthermore, it would allow for the movement to a more flexible position from one where absolute certainty of income is guaranteed in advance to one where a target income payment is aimed for with a lower guaranteed income floor.

30. Do existing protection arrangements for DC products provide sufficient protection for members in the event of provider insolvency?

This is a complex area. The protection afforded to members is dependent on the structure of the scheme. For example members of contract-based DC schemes have recourse to the FSCS, whereas members of occupational DC don't have that protection. While they do have other protection associated with trust law, this makes communication complicated, particularly in a world where it's expected that savers may spend time in a variety of different types of provision over their lifetimes.

Furthermore, there are particular issues whereby reinsurance arrangements in place between two life companies aren't eligible for claims under the FSCS in the event of insolvency, leading to gaps in FSCS cover even between members of contract-based schemes.

Similarly where occupational DC schemes access fund management through policies of insurance, they're eligible for claims under FSCS, but where they invest via segregated mandates or other pooled fund structures they have no protection from FSCS.

None of the arrangements outlined above leads to a particularly coherent, straightforward or reassuring message for consumers or their employers, as to whether savings are protected in the event of provider or counterparty failure.

31. Would any protection mechanism need to apply in order to provide extra security for members and reassurance for the employer that it would not be liable in the event of any deficits arising?

We think in the context of multi-employer schemes this is less likely to be an issue. However we return to our early point about who's best placed to meet extreme downside tail risk or other unexpected significant risk events, such as counterparty failure and financial crime etc. In pure DC it is an individual saver who has to shoulder the totality of these risks. A reasonable question the DA debate has generated is, is this optimal? What are the likely behavioural responses to unexpected significant risk events occurring? What are the likely behavioural responses if there's an unsatisfactory narrative to the possibility of these events happening in the future?

32. Are these models likely to be an attractive option for employers and members?

We have little evidence to suggest that greater protection for workers is high on the agenda of most employers currently. This may well change once the automatic enrolment duties become more bedded in, and particularly larger employers review the benefits they're providing and how they compare to their corporate competitors. However, at present most of our dealings with employers have seen investment product features being a second order issue when selecting an automatic enrolment scheme to fulfil the new employer duties.

We think elements of a number of these models will be attractive to members at different stages of their savings career. As we've outlined above, we're not convinced that members want total guarantees for their entire savings career, nor are they necessarily willing to pay for them, whether in upfront costs or a willingness to accept lower returns. Indeed our research suggests that most members are surprised to find out that their pension isn't guaranteed already. We think that a narrative regarding security and expected outcomes for DA schemes covering four stages of saving and decumulating could be as follows:

- early years – your contributions are safe
- mid years – your pot is growing and any volatility you see will have clear downside risk management or some form of 'floor protection'
- approaching retirement (10 - 20 years out) – a retirement income is incrementally being guaranteed and banked
- into retirement – much of your income is certain, but you can continue to build up further benefits and see growth on a small part of your pot and any additional pension contributions.

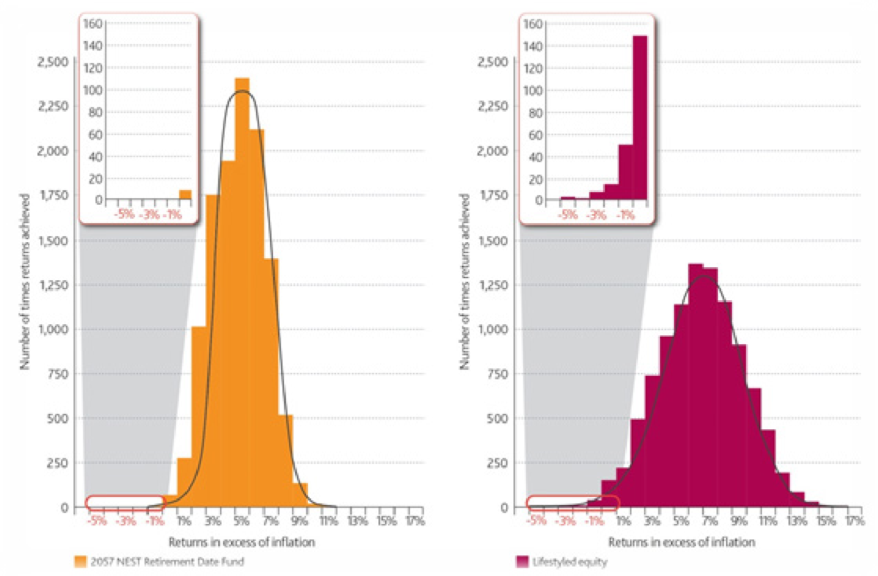
The models set out in the paper, or other innovations, could be used to deliver this kind of experience, that balances the need for sustainable growth in real terms and the desire for greater certainty.

33. On model 4 – pensions income builder – what are your views on this model in which members are in effect deploying their own capital to guarantee their own entitlements?

Of all the models this is the one we have serious reservations about, as the dangers of over promising appear the greatest and the uncertainty of locking in multiple generations over decades appears to require a degree of optimism and confidence about events into the future that may well be unfounded. We also suspect a high level of compulsion would be required, which appears to go against the grain of the UK savings culture.

We also note the modelling of table 3 looks very similar to the kind of modelled results that NEST's investment strategy achieves using similar stochastic modelling techniques - relative to a traditional DC approach (see Figure 1). We'd suggest the kind of reduced dispersion of outcomes, without sacrificing too much upside potential and still providing significant downside protection, is achievable within conventional DC.

Figure 1 – stochastic projection of NEST's investment strategy vs a traditional equity lifestyled approach[4]



40. Do you agree that creating a unified and identifiable legislative framework that brings together the legislation relating to DA schemes would be preferable to simply amending existing legislation?

There's some attraction in the concept of having a new simplified regulatory regime for DA schemes that doesn't seek to just bend existing legislation. Communication and investment requirements that are present for the existing DC regime, which in itself is often heavily influenced by Pensions Act 95 Defined Benefit legislation – may not be fit for purpose for a new type of provision.

41. Do you have any comments on how to characterise the defining characteristics of DA pensions?

We think the crucial difference between DA and pure DC must include a reference to some element of income certainty in retirement. This doesn't need to be for the whole lifecycle of saving but reasonably should be available at least ten years out from expected retirement. How that protection is implemented, that is, through the purchase of existing income guarantee products, or through self-annuitisation and the creation of internal reserve funds should be open to providers within a proportionate regulatory framework aimed at providing adequate consumer protection.

Other elements we believe could form parts of DA type schemes are efforts to impose a floor to the possibility of capital loss, be that contributions made or contributions plus growth, in order to deal with the tendency to see any capital loss as catastrophic and liable to lead to total loss. However, we believe these techniques would be best suited for short periods of time, where evidence suggests there are real 'pinch points' to consumer confidence.

We think one such pinch point is when younger members first start saving for a pension. We believe this element would be of more benefit to younger savers whom our research suggests are most likely to be put off by market volatility when starting their savings journey and most likely to give up on saving at the first sign of trouble. This would also have the additional benefit of being relatively inexpensive 'insurance' to provide, as the amount of capital to be protected will generally be marginal. In such a situation it would be critical to understand the distinction between guaranteeing that early years' contributions will be in a pot at the end of a savings career versus guaranteeing against fluctuations in pot value from year to year in the early stages of a savings lifecycle. Careful consideration should be given to how this information is communicated, if at all, through things like annual statements.

Such an approach is also unlikely to have noticeably detrimental effects to growth potential – again because the capital at play is relatively small. However, attempting to guarantee all nominal contributions would in our view fall into the trap outlined in the paper - high costs and investment strategies ultimately only targeting the risk-free rate.

[4] Probability distribution generated using 'economic factor modelling' methodology, a statistical (stochastic) method of generating a distribution of possible outcomes using 10,000 potential future economic scenarios. NEST glidepath – 45 years of contributions, including five years in the Foundation phase, five years moving between the Foundation and Growth phases, 25 years in the Growth phase and 10 years Consolidation phase. Lifecycled equity portfolio – 35 years 100 per cent equity investment, followed by 10 years linear lifestyling (to 75 per cent bonds and 25 per cent cash).

We also believe there's merit in considering whether elements of smoothing present in traditional with-profits funds could be another technique – particularly within growth phases of a savings vehicle's lifecycle – to reduce nervousness around pot volatility. While with-profits approaches involve the sacrificing of some upside returns for some members in order to smooth poor performance experienced by others, our research suggests this is exactly the sort of trade-off the target market would be willing to make and be a better fit with their concept of what saving for the future should be like.

42. Do you agree that it makes sense to define DB schemes in their own right rather than simply by contrast to money purchase?

Yes.

43. Do you agree that defining DA, DB and money purchase schemes should facilitate clear and proportionate regulation according to scheme type?

Yes.

44. Do you have any comments in relation to the suggested definitions of DA, DB and money purchase schemes?

See our response to question 41.

52. What specific areas should we address in relation to governance and member communications for DA schemes?

The levels of governance required when offering greater certainty are likely to be higher than is perhaps present in much traditional DC. A useful comparison may be with the kind of oversight seen currently in with-profits funds. Higher governance for DA is likely to be required, for example when considering what the level of certainty and guarantee is for savers throughout their lifecycle. We suspect an approach would require judgement and a likely need for a degree of flexibility to respond to evolving market and economic conditions, as well as developments in member demography and member expectation. We also believe careful consideration would be required as to levels of capital needed to cover greater certainty, and what happens in the event of counterparty failure. A set, forget and hope approach to any DA provision is in our view likely to undermine overall confidence in the savings system.

While with-profits approaches have suffered from a poor press in recent years, ironically the quality of governance and oversight seen today is radically different (for the better) than the environment seen before the with-profits collapse. The lessons from the past are the danger of under governance, poor control and over promising. There's also a salutary lesson of the danger of a broad interpretation and confusion of what's being promised, leading to the risk of judicial intervention to provide clarity, but often to the detriment of the majority of potential beneficiaries.

In terms of communication we believe at the very least careful thought should be given to how outcomes are projected and communicated. At the moment we suspect within the current regime there's too much focus on current pot sizes and recent performance, leading to short-term thinking and potentially short-term alarm. The direction of travel should be about encouraging a focus on incomes in retirement and the importance of individuals' own actions at securing better outcomes.

There's a danger that too much attention on types of provision or clever ways of investing and financial engineering is seen as a panacea to not contributing sufficiently. Regardless of the savings vehicle used, one of the biggest determinants of likely outcomes is and will remain, the amount actually saved, which can be both a difficult, but ultimately empowering message for savers if communicated correctly.

The other element of determining outcomes that has a tendency to be overlooked is the impact of charges on final retirement incomes. We'd be concerned about any DA innovation that promised greater certainty while eroding incomes due to high and complex charging structures. Our research suggests that members have a limited tolerance to the concept of paying for guarantees and are likely to be even more disillusioned with long-term saving if they feel they're being ripped off.

Question 34: Do you agree that CDC schemes have the potential to provide more stable outcomes on average than traditional DC schemes?

Yes, in principle we agree with the hypothesis that CDC schemes have the potential to provide more stable outcomes than a pure DC scheme invested in a similar way. We agree with the points raised in the paper that not having to decumulate into annuity matching assets as part of a lifestyle approach should mean that contributions can benefit from exposure to growth seeking assets for longer. However, depending on the maturity of the CDC scheme a certain degree of liability matching for pensions in payment will be required.

We're not convinced that the Aon Hewitt modelling is necessarily starting with a level playing field in its evaluation of CDC and traditional DC. The decumulation phase of DC weighs heavily but the requirement for meeting liabilities in a CDC approach is potentially underrepresented. CDC, like DB will have to match assets to the income that's being generated for the pay-out phase. The question would be, could that be done more efficiently than through the purchase of annuities from third party insurance companies, and what level of capital reserves would be required to meet unexpected risks, most notably changes in mortality assumptions?

We also agree that the benefits of scale and the pooling of assets should help drive costs down and make the use of large and illiquid asset classes more attractive due to superior purchasing power. Many of these benefits can be realised by large, pure DC schemes. NEST has kept investment costs very low due to a combination of being able to negotiate low fees for a diverse group of assets and by utilising innovative approaches to delivery, such as our target date fund approach. Both of these have only been possible because of NEST's expected future scale and these cost savings are unlikely to be realised by smaller DC schemes.

Question 35: Given there is no tradition of risk sharing between pension scheme members in the UK, are individuals going to be willing to share the benefits of protection from downturns in the market and increased certainty of outcome, with the potential disadvantages of intergenerational risk transfer?

We think the popularity of with-profits funds prior to Equitable Life's difficulties suggests that there has been a tradition of a certain degree of risk sharing. Similarly the pervasiveness of the use of annuities and mortality risk pooling suggest the UK savings' population has had exposure to a variety of different risk sharing techniques, without causing undue concern.

As seen from NEST's member research over the last few years we'd also argue that intergenerational transfer is a concept that's unlikely to be on the radar for most of the target market of automatic enrolment savers. The lack of familiarity with how pensions work, suggests the challenge isn't, 'why would I share risk across generations', but 'why would I take any risk with my retirement savings at all?'

All of our research evidence points to the overwhelming strength of prospect theory and that people are willing to trade away huge upside potential to protect themselves from even remote possibilities of downside. This doesn't necessarily mean it's in savers' best interests for fiduciaries to act on this evidence, but it should certainly feature in considerations of scheme design and governance.

Question 36: Is a CDC scheme designed to manage funding deficits by cutting benefits in payment going to be acceptable in the UK where traditionally maintaining the value of benefits in payment has been an overriding priority?

We believe that 'traditionally' isn't necessarily a concept that needs to be applied to the automatic enrolment generation. However, cutting benefits in payment may be an extremely challenging concept to get across to savers. There's significant behavioural economics evidence around the power of endowment effects[5]. A strength of the current pure DC system, we'd argue, is that the purchase of an annuity, regardless of whether it's done efficiently, at the right time, or using the most suitable product, at least provides a 'guaranteed income for life'. The danger of a CDC approach is that while there could undoubtedly be significant benefits in the accumulation phase, the lack of certainty of outcomes and the potential for those uncertain outcomes to continue to be uncertain into retirement is likely to cause as much confusion and consternation to inexperienced savers as pure DC does.

[5] people ascribe more value to things merely because they own them

We'd note however that a useful existing UK comparison could be the PPF. In extremis the PPF has the power to cut benefits in payment, though it never has. But this doesn't seem to have had a negative effect in terms of confidence for PPF members. Whether that confidence would hold in the event of benefits being reduced will hopefully not need to be tested.

Question 37: What levels of funding do you consider would be appropriate to ensure that a CDC scheme has sufficient capital to meet the liabilities and minimise the risk of benefits in payment being cut?

NEST hasn't performed any modelling on this issue at present.

Question 38: Given the need for scale and an ongoing in-flow of new members to ensure the sustainability of a CDC scheme, will it be possible to set up a scheme without some form of government intervention?

We think some form of government intervention is likely to be inevitable for CDC to work effectively. We think greater compulsion and reduced flexibility in terms of transferring out of a CDC scheme would be required features. Other initiatives that could prove helpful for CDC would be the issuing of longevity bonds and government charging a risk premium for issuing the bonds. Longevity bonds would reduce the risk of schemes getting into difficulties and ensure appropriate risk premiums paid to government for assuming the tail risk.

Question 39: As a mutual model, it's been suggested that CDC schemes might prove attractive to the trades unions and other social partners – might this be an option worth exploring?

NEST consulted on the issue of risk sharing and approaches such as CDC in its 2009 investment consultation.
nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/investment-consultation-response,PDF.pdf

While a majority of respondents thought that in the early years of NEST's evolution the Trustee should concentrate on designing a high quality DC approach, there was noticeable support for greater innovation aimed at increasing consumer confidence from the trade union movement. The relevant section from the consultation response is as follows:

Different approaches – risk sharing

3.35 Fewer respondents answered the question **3.35** of risk sharing directly. Instead, several focused on the issue of volatility smoothing or with-profits, where investment returns are held back in good years to boost and smooth return in bad years. Of those who addressed risk sharing within and across generations of scheme members, the majority thought that risk sharing in its current forms would not be appropriate for personal accounts [NEST], at least in the early years. Respondents thought that risk sharing may create challenges for delivering a low-charge and simple scheme. However, most respondents acknowledged that the concept of risk sharing is appealing to protect against unevenness in member outcomes in retirement, and thought these approaches were worth further investigation by personal accounts [NEST]. For example, the Trades Union Congress explained that:

'We think it's extremely worthwhile to develop approaches that could collectivise risk and minimise volatility. This is an extremely exciting area of work with wider relevance in today's increasingly defined contribution world.'

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