Investment Management Association

IMA RESPONSE TO DWP CALL FOR EVIDENCE

"Supporting automatic enrolment: A call for evidence on the impact of the annual contribution limit and the restriction on transfers on the National Employment Savings Trust"

January 2013

SUMMARY

1. The IMA welcomes the opportunity to respond to the Government's call for evidence on the impact of the annual contribution limit and the prohibition on transfers on the National Employment Savings Trust (NEST).[1] Our response is in two main parts. Part One provides a series of comments on the history and current context of the debate on NEST restrictions. Part Two provides answers to specific questions in the consultation.

2. The IMA has consistently backed, and contributed to, the development of NEST since its creation was first proposed by the Pensions Commission in 2005 as the National Pension Savings Scheme (NPSS). The investment management industry recognises the importance of ensuring that access to quality pension provision is available to all employees at a reasonable cost. In broad terms, the market failure identified by the Commission justified Government intervention to ensure that objective could be met in specific parts of the labour market.

3. We originally supported the contribution cap and transfer restrictions imposed on the NPSS as a way to focus it on the core target market identified by the Pensions Commission. However, we recognise that it has now been seven years since the Commission proposals and that the commercial and policy environment has evolved. Recommendations from both the 2010 Review (Making Automatic Enrolment Work) and the Work and Pensions Select Committee have highlighted considerable unease about the potential impact of these restrictions.

4. In terms of immediate change, the IMA accepts that the proposed 'pot follows member' consolidation exercise cannot work if NEST is hermetically sealed from the wider market. Removing transfer restrictions on NEST in order to facilitate this policy is an appropriate course of action.

5. We also recognise that there are strong arguments for considering changes to the annual contribution limit. However, we would wish to see those arguments backed by convincing evidence about their likely impacts before we would support any change to the limit. Specifically, two things would have to be shown:

    a. That the ability to operate without any contribution cap (in conjunction with relaxed restrictions on transfers) would not extend NEST's role beyond that originally intended and insodoing constitute an unfair commercial advantage for a Government-backed player. Or to put it another way, that the principal remaining requirements – universal service obligation and fixed price tariff – would be enough to focus NEST on its target market and justify both a Government loan and the potential benefit of being perceived as Government-backed.

    b. That employers in the target market for NEST are faced with complexity of decision-making as a result of the contribution cap which poses a genuine

[1] The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of around £4.2 trillion of assets in the UK on behalf of domestic and overseas investors.

threat to the success of the automatic enrolment policy and consumer outcomes.

6. In this respect, it is currently unclear whether the real issue here is about the commercial terms of operation for NEST or about the dangers posed by anticipated employer behaviour in selecting schemes for automatic enrolment. Available evidence is often limited or anecdotal, and we hope that the current call for evidence will help to advance the debate.

PART ONE: ROLE OF NEST AND THE ISSUE OF RESTRICTIONS

7. It is helpful to recall that the original proposal for the contribution limit came not from the financial services industry or indeed the Government. It was contained within the Pensions Commission Second Report. The Pensions Commission, concerned partly with concentration risk, noted that an approach based on a limit of about twice the default contribution rate (16% of relevant earnings) "would mean that lower earners would effectively be free of any cap…while limiting the extent to which higher earners could use the NPSS as a low-cost alternative for pension saving that is already in many cases occurring."[2]

8. Although many in the pensions industry were initially opposed to the NPSS, the IMA took the view that the NPSS was a workable solution that should be encouraged for the key target employee market as defined by the Pensions Commission (people of average income and below working in small and medium firms). However, it was also important for us to ensure that the NPSS should remain focused on that target market. There was no justification in 2005 – and there remains none in 2012 – for what could potentially become a quasi-nationalisation of large parts of the long-term savings market.

9. In 2005, the IMA and others saw three sets of risks posed by automatic enrolment if the NPSS was left totally without restrictions:

    a. For Government, it was possible that a dominant pension provider could emerge as both new and existing scheme members gravitated to the NPSS. This created both a potential competition law problem and a concentration risk with respect to the management of the nation's savings that the Pensions Commission had already identified.

    b. For customers (in this case, both employers choosing workplace schemes and scheme members themselves), a dominant provider in the shape of the NPSS created similar potential risks to dominance in any other market, whereby diminished choice and a lack of competition could result in poor savings outcomes.

    c. For the pensions – and asset management – industry, built on the principle of competition and diversity, there was also a clear commercial threat if the NPSS became a dominant player.

[2] Pensions Commission, *A New Pension Settlement for the Twenty-First Century The Second Report of the Pensions Commission* (2005), p.360.

10. Successful management of these risks, in the context of considerable uncertainty about how the policy environment would develop, was essential for the success of the 'consensus' that eventually saw broad support from the pensions industry for the NPSS. It was the central justification for the imposition of both the contribution cap and the restrictions on transfers.[3] Government also included other measures which are intended to ensure NEST serves its target market: first, a universal service provision that does not allow NEST to turn down business: and second, an inability to vary pricing in response to specific scheme and member characteristics.

Evolution of Market and Need for Review

11. We recognise that the pensions market and the public policy environment have both evolved considerably since 2005:

    a. Within the pensions market, there are both new entrants and signs that NEST may face competition in its core target market. The risk of dominance that was a legitimate fear seven years ago has clearly diminished.

    b. The creation of NEST has helped to focus the pension reform debate on the question of costs and charges. As we discuss below (see paragraph 20), we do not believe a 'race to the bottom' on charges is healthy, but greater awareness of the importance of charges in long-term savings vehicles is clearly important.

    c. DWP policy has started to focus on the importance of minimising multiple and stranded small pots, which now involves a state objective to move towards a 'pot follows member' approach.

12. In light of these changes, it is reasonable to consider whether the original restrictions on transfers into and out of NEST and contribution levels into NEST accounts are still valid, particularly if other constraints are maintained which we would argue they should be.

13. With respect to restrictions on transfers in and out of NEST, we believe that change will be needed. Current Government proposals to facilitate small pot consolidation through the accumulation phase are likely to be seriously impeded if those restrictions are not relaxed. The IMA believes that this constitutes a clear reason to end the isolation of NEST from the wider pensions market. The ban both on transfers in and transfers out should be removed for the purposes of pension consolidation.

14. However, we have not yet seen compelling and consistent evidence that the cap on contributions is causing a major challenge to employer decision-making and the success of NEST in securing business in its core target market. Furthermore, we believe that the unusual nature of the Government intervention that created NEST, including funding support that required EC state aid approval, sets a high hurdle for the removal of the cap as a step towards 'normalisation' of NEST's activities in the private long-term savings market.

[3] A summary of IMA positions can be found here: http://www.investmentuk.org/assets/files/research/20060901-finalresponsetowhitepaper.pdf

15. We acknowledge that the decision for Government in this area is finely balanced, particularly given NEST's public service obligations which will always set it apart and constitute, in some respects, a source of commercial disadvantage. There will inevitably also be a temptation to move pre-emptively rather than wait for problems to emerge. The evidence gap on employer behaviour is not helped by the fact that employers face a raft of immediate challenges in the current economic climate that may militate against advanced preparation for the automatic enrolment duties that lie ahead.

16. Set against the arguments for 'normalisation' remain reasons for caution. NEST is effectively a Government-created entity, whose creation was justified on the basis of a focus on specific areas of market failure on the supply side. Announcements of contract wins with major household names suggest that NEST may be operating beyond those areas of market failure. The apparent willingness by some employers to segment pension provision also suggests that the impact of the contribution cap on employer decision-making is not clear cut.

17. With respect to segmentation, there is an additional point relating to the needs of different kinds of employee. Some of the arguments in favour of removing the contribution cap have implied that it would facilitate the use of NEST by small employers who might otherwise have had to automatically enrol higher paid employees into an alternative scheme. Policy intention aside, it should be emphasised that the NEST product offering, particularly the default strategy, has not been designed for such employees. The governance discussions within NEST, informed by extensive research, have focused on the original target market envisaged by the Pensions Commission. Suitability for others should not be assumed as a matter of course. Indeed, it is a reason why some employers may in fact segment regardless of the existence of a contribution cap.

18. We would therefore suggest two evidence tests before removal of the contribution cap should be considered:

    a. A detailed demonstration that favourable Government loan terms to NEST can be justified on the basis of the NEST universal service obligation, together with an exclusive focus on pensions charged on the same fee scale. In other words, that the ability to operate without any contribution cap (possibly in conjunction with relaxed restrictions on transfers) would not constitute an unfair commercial advantage for a Government-backed player. It should be remembered in this respect that pay-back periods for private pension providers are long, often 8-10 years, and cost of capital is therefore a significant issue.

    a. Detailed exploration of the actual complexities facing employers in choosing between NEST and other schemes given the existence of the current restrictions. The call for evidence refers to the risk of "severe complexity" for businesses. There are many opinions on this issue, but more precise evidence is necessary. We note, for example, a survey by Watson Wyatt which found that obstacles to using NEST for large employers had little to do with contribution caps.[4] Can this be further validated and what is the

[4] As reported in Professional Pensions, 26 September 2012, 'Branding a bigger barrier than contribution cap for NEST'.

position among the small and medium-sized enterprise (SME) core target market?

PART TWO: RESPONSES TO SPECIFIC QUESTIONS

Chapter 3 – The Supply Side Landscape

Q1. What evidence is there that the current downward pressure on charges is sustainable as smaller, less profitable employers start to meet their automatic enrolment duties? Is this relevant in considering the impact of the annual contribution limit and the transfer restrictions on NEST?

19. The economics of serving small employers will inevitably differ from those serving the large employers currently subject to auto-enrolment duties. But not all smaller employers are the same and Q1 focuses on 'downward pressure', which is about the direction of travel, rather than absolute levels of charge. Price competition in any market is driven by a complex dynamic, relating to the nature of the product itself, the shape of the product market and customer behaviour, Government and regulatory policy.

20. As a general point to note, pensions are neither a commoditised nor an easily predictable product in terms of returns and there is no necessary connection between level of price and consumer outcome. This makes the task for decision-makers challenging and also explains the importance of working towards good governance, particularly on the investment side, to ensure that investment decisions are made with regard to clear member objectives.

21. Nonetheless, charges are clearly a key consideration and downside pressure can come from a number of sources:

    a. *The achievement of scale*, in turn facilitated by strong persistency at scheme member level (and not just relevant to the largest employers). Scale matters not just in investment terms, but for administration too. One simple demonstration of this internationally came from the Thrift Savings Plan (TSP) in the US. In a paper written at the beginning of the current UK reform process in 2005, the IMA showed how the TSP had exceptionally low headline charges, even with unit administration costs significantly higher than those in Sweden, where a smaller asset base in the Premiepensionsmyndigheten (PPM, the Premium Pension Authority) pushed up the ad valorem charge.[5]

    b. *Containment of distribution costs*. One of the reasons it has been more expensive traditionally to serve the SME market in the UK related to business acquisition costs. Reducing these was an important factor behind the suggestion by the Pensions Commission to create the NPSS.[6]

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[5] http://www.investmentuk.org/assets/files/research/20051124-individualretirmentaccounts.pdf. See p.16.

[6] See Pensions Commission, *Pensions: Challenges and Choices: The First Report of the Pensions Commission* (2005), p. 220

c. *Behaviour of scheme decision-makers*. From a demand-side perspective, customer pressure (and in this context, we include key decision-makers in workplace schemes) can also serve to sharpen competition. And, in this respect, the creation of NEST is clearly having an impact on the competitive environment. Price-aware customers can help to encourage businesses to focus on their cost base, identifying scope for change and potentially eliminating inefficiencies. Again, however, one challenge for policymakers and the industry here is to ensure that employers choosing workplace schemes understand that areas such as investment performance and quality of administration matter. Research from the NAPF pointed to a clear difference between large and smaller employers in this area.[7]

22. The answer to Q.1 will therefore lie in the way in which some of these elements play out during automatic enrolment. The size of an employer will not in isolation determine whether they are inherently unprofitable. However, if they have low-paid workers who may neither be persistent in their saving nor move beyond minimum contribution levels, then profitability may be extremely difficult to achieve, even over very long periods of time.

23. This issue is a challenge for NEST as much as for the wider market. NEST clearly does not exist in a different economic universe to existing providers. The 0.3% long-term target for charges will only be achieved on an unsubsidised basis if NEST can build sufficient scale. The additional delays to NEST breaking even that are perceived to result from measures to focus it on its target market are recognised in the nature and terms of financial support received from the UK Government.

24. Indeed, as we outline in our general comments, we believe that this commercial issue needs greater recognition in the call for evidence. The potential difficulties arising from the contribution cap may be as much about the financial evolution of NEST as about the inherent problems for small employers who may decide to segment their provision. What scheme segmentation at employer level would do is diminish a cross-subsidy that otherwise shortens the ‘J’ curve cost recovery challenge that NEST, together with all pension providers, faces.

25. In this respect, the cap is relevant to Q1, but it should also be remembered that what will matter to NEST is not profitability at individual employer level, but across its overall book of business. While individual providers may choose not to take on business that they believe will never be profitable at scheme level, NEST will have to.

Q2. What evidence is there that the current pension industry has the capacity to serve the peaks in employer demand and put solutions in place to meet the demand for good quality, low-cost schemes? Is this relevant in considering the impact of the annual contribution limit and the transfer restrictions on NEST?

26. We do not have evidence to offer on the first part of this question relating to peaks in employer demand, but would observe that the pensions industry can supply good quality, low-cost schemes, and is already doing so. We would also observe that if the capacity is not available in the coming years, private sector providers will not accept business and NEST will win that business. The key challenge therefore may

[7] NAPF, *Telling Employers About DC Pension Charges*, 2012.

not be private sector capacity per se, but the planning cycle for employers subject to automatic enrolment duties. We do not therefore accept that there is an immediate relevance of capacity for the debate on contribution limit and transfers restrictions.

Q3. Do you agree that NEST should be able to fully participate in any automatic transfer solution?

27. Automatic transfers, if introduced, should be allowed for all defined contribution schemes, including NEST. The policy intent – to minimise stranded pots – will be undermined if NEST were to be excluded.

Chapter 4 – Employer Choice

Q4. What evidence is there that the annual contribution limit and the transfer restrictions placed on NEST are or will influence employers' decision making?
Q5. Is there evidence of employers feeling unable to choose NEST for their workers due to the annual contribution limit and/or the transfer restrictions?
Q6. Is there evidence that employers (of any size) are prioritising or will prioritise a single scheme solution for automatic enrolment?
Q7. Is the existence of the annual contribution limit and/or the transfer restrictions on NEST adding to the cost to employers of responding to automatic enrolment?
Q8. Is there evidence that the impact of the annual contribution limit and/or the transfer restrictions on employer decisions is leading to or will lead to sub-optimal pension outcomes for workers?
Q9. What factors should the Government take into account when considering the likely impact of the annual contribution limit and the transfer restrictions on employer choice as smaller employers are brought into the reforms?

28. We do not have specific insights in this area, and await with interest the views of those who are able to capture employer behaviour, both current and anticipated.

Chapter 5 – Consumer Interests

Q10. How should the Government best protect consumer interests? Would a different policy response be appropriate for smaller employers?

29. The best protection of consumer interests comes with ensuring access to well-governed schemes that benefit from economies of scale and are not subject to distribution costs that significantly increase overall charge levels. This consideration lay behind the creation of NEST, providing a scheme that employers not well served by existing private sector provision could access. The current contribution limit (£4,400 in 2012 terms) is equivalent to around 17% of national median earnings, broadly the level envisaged by the Pensions Commission. The expectation of the Commission was that, combined with the state pension, maximum NEST contributions would create a total pension equivalent to around 60-66% of median earnings at the point of retirement.[8]

[8] Pensions Commission, *A New Pension Settlement for the Twenty-First Century*

30. Issues raised in the call for evidence, such as creating facilities for those that might have a bequest or other form of windfall, have been widely discussed before. It is clear that there will be some individuals for whom the contribution limitation is not optimal in terms of concentrating their retirement saving in one vehicle. However, NEST is primarily a very specific kind of workplace pension scheme, not a personal savings product. For those who experience a significant change of financial circumstances that allow significant additional savings above and beyond the annual NEST cap, the private and government product market offers a range of choices, including tax-advantaged products.

31. With respect to the second part of the question – a regime specific to small employers - it is not totally clear in the consultation paper what is meant by this. The case for differential rules could be made in theory, but is weak in practice. If Government were to allow higher contribution levels to NEST from employees / employer schemes within the core target market, NEST scheme members in other employer schemes may justifiably feel aggrieved.

Q11. Are there other aspects of consumer detriment relating to the annual contribution limit and/or the transfer restrictions on NEST that the Government should consider?

32. The call for evidence covers the key issues relating to the restrictions on NEST, but raises important questions around employer behaviour with implications for consumer outcomes. These have little to do with contribution limits or transfer restrictions per se, but relate to standards of scheme selection, which in turn lead to the issue of overall standards of governance. Employers may choose a scheme other than NEST for a variety of reasons, or they may choose NEST for a variety of reasons. Either way, it is essential that they have support and guidance to make that choice. The advantage of NEST is that it comes with a government imprimatur. Those employers, particularly in the core target market, who consider alternative schemes, must be able to understand the critical differentiators between different offerings. This is far from straightforward and requires more support from Government, regulators and industry.

Chapter 6 – Discussion of Possible Alternative Approaches

Approach 1: Removing the annual contribution limit and the transfer restrictions altogether at the end of staging (February 2018)

Q12. Is the end of implementation the appropriate time to remove the annual contribution limit and the transfer restrictions?

33. The timing of any removal of the annual contribution limit and transfer restrictions should be determined by the policy goal it is intending to serve. If the Government believes that there is a serious threat to automatic enrolment and can ensure that NEST will not be operating at an unfair advantage, then it could argue a public interest case to commit to remove the restrictions in 2018. As outlined above, we are not yet convinced that a commitment to remove the contribution limit would be

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The Second Report of the Pensions Commission (2005), p.19.

appropriate. The original intention behind the 2017 review was to have the evidence base to take a clear decision.

34. But the critical questions remain the same, whether the restrictions are lifted in 2014, 2018 or 2022. Would NEST operating with fewer restrictions on scheme member behaviour move beyond its original remit? Would the level of Government support mean that it was operating at an unfair advantage? Would employers in the core target market find it easier to choose NEST without the restrictions?

Q13. What would be the impact on individuals, employers, NEST and other pension providers of this approach?

35. It is important to underline the uncertainty surrounding the whole automatic enrolment process, which was a point emphasised in the 2010 Review. If the proponents of removing the restrictions are correct, then employers may find it more straightforward to fulfil their automatic enrolment responsibilities; NEST would acquire both greater employer share within its target market and it would have a more diverse membership in salary terms. However, they may be wrong and NEST could find that it is able to operate across the pensions market, seeking more profitable business to offset its universal service obligation. In such a scenario, there could be market distortion.

Approach 2: Enabling automatic transfers

Q14. Do you agree that NEST should be able to participate in an automatic transfer system?

36. Yes.

Q15. What would be the impact on individuals, employers, NEST and other pension providers of this approach?

37. The impact of implementing a 'pot follows member' policy has implications well beyond NEST and the restrictions debate surrounding NEST. Given the challenges and complexities of automatic enrolment, we would encourage Government to think carefully about the timing of additional policy measures.

Approach 3: Individual transfers / Approach 4: Bulk transfers into NEST

Q16. Should NEST members be allowed the same transfer rights as members of other occupational pension schemes, and if so from when?
Q17. What would be the impact on individuals, employers, NEST and other pension providers of this approach?
Q18. Should bulk transfers into NEST be facilitated?
Q19. What would be the impact on individuals, employers, NEST and other pension providers of each of these approaches?

38. The issue of transfers cannot be considered in isolation. We believe there needs to be a detailed examination of the implications stemming from combinations of policy reforms. Both removing contribution caps and facilitating transfers into NEST on an unrestricted basis could have significant consequences for existing provision. It was in large part the uncertainties around these consequences that justified the imposition of the original restrictions.

Approach 5: The annual contribution limit

Q20. Are changes to the annual contribution limit required?
Q21. What would be the impact on individuals, employers, NEST and other pension providers of each of these approaches?

39. We wish to see greater evidence concerning employer behaviour and the relationship between government financial support for NEST and its operating constraints. See, in particular, our comments in paragraphs 14 to 18 above, and in paragraphs 33-34.

All Approaches

Q22. Which of the approaches – or combinations of approaches – achieve the optimum balance between focussing NEST on its target market and enabling employers to meet their automatic enrolment duties whilst supporting good pension savings outcomes for individuals?

40. Our current view is that making it easier to transfer in and out of NEST, while maintaining a contribution cap, is the best combination.

Q23. Are there alternative proposals which address the concerns that have been raised?

41. We are not aware of alternative proposals that address the concerns.