Securing the future of pensions

Regulatory differences between occupational and workplace personal pensions:

A response by the National Association of Pension Funds

Contents

Executive Summary

Regulatory differences

1. The regulatory differences between trust and contract-based pensions are deep and complex. This call for evidence does not focus on the most important difference, which is the strong governance provided by trustees that greatly benefits and protects scheme members. Although some employers do voluntarily apply good governance to contract-based schemes, the 'governance vacuum' that exists across most contract-based provision poses a danger to the long term success of auto-enrolment.

2. There is no evidence that regulatory differences are pushing employers towards trust-based provision. In fact, the opposite is the case and NAPF members continue to switch to contract-based provision. In 2005, 89% of NAPF members reported that their main DC scheme was trust-based. In 2010 this had plummeted to 49%, with the majority of NAPF members now having contract-based DC schemes[1].

3. Concerns have been expressed about commercial Master Trust arrangements being marketed around the existence of short service refunds. In reality Master Trusts are likely to be more attractive to employers who currently have a trust-based scheme, rather than those who have already switched to contract-based schemes. Making sure the regulation and structure of Master Trusts is robust would be the best remedy to any concerns with employers using these schemes to avoid their duties under auto-enrolment, rather than changing long-established rules on vesting and refunds for all trust-based schemes.

Short Service Refunds

4. A survey of NAPF members[2] has found that 89% of trust-based schemes allow refunds and that the average refund of employee contributions is around £750. DWP research[3] shows that the scheme uses the retained employer contribution to help pay for the costs of the scheme governance, advice, administration and communications, all of which benefit members.

5. 87% of NAPF members with open trust based schemes believe that the flexibility to give refunds for up to 2 years should be retained. NAPF members are very concerned about the consequences of preventing refunds. 53% of those who want to retain refunds believe stopping them will increase employer costs. And 21% believe that their employer would consider closing the scheme and moving to a contract-based pension instead. This would mean employees would lose out on the benefits and protection of trustee governance, and

[1] NAPF Annual Survey 2010, NAPF , March 2011.
[2] A survey of NAPF members was conducted in April 2011. Details in the appendix to this paper.
[3] Charging levels and structures in money-purchase pension schemes: Report of a quantitative survey, DWP Research Report 630, 2010.

would potentially see contributions levelled down to the minimum required under the auto-enrolment regulations.

6. The survey also found that 95% of those who want to retain refunds believe the scheme will be burdened by large numbers of small pots if refunds are banned. In many cases the costs of administration can be larger than the value of the pots. One example of where this has already happened is the Local Government Pension Scheme in England and Wales where the rules were changed to vest pensions after 3 months rather than 2 years. There are now well over 100,000 'trivial' pots worth less than £2 a week, which create such a significant administration burden that local authorities are lobbying to reinstate refunds up to 2 years.

7. Many NAPF members would like to encourage more employees to take transfers rather than refunds, but the rules are very bureaucratic and make it hard for employees to transfer without expensive advice. Allowing trustees to automatically transfer small pots to a suitable scheme would reduce the number of refunds and help meet the Government's objective of getting more people saving more into a pension. The Government should publish a consultation paper looking at options for improving and encouraging transfers. No changes should be considered to rules on refunds and vesting until transfers have been made easier.

8. 60% of NAPF members who want to keep refunds believe that their scheme is already facing enough regulatory change without the DWP adding more. The Coalition Agreement commits the Government to reducing regulatory burdens and reinvigorating occupational pensions, both of which are difficult to reconcile with proposals to change rules on vesting and refunds. Employers want greater certainty to plan for auto-enrolment, but this discussion paper makes the situation less certain. Rather than rushing to make any change, and risking the unnecessary closure of high-quality trust-based scheme, the Government should wait to see if any real problems with refunds do occur when auto-enrolment is introduced. The issue of refunds could then be reviewed in the light of evidence as part of the broader review planned for 2017.

Summary of NAPF Recommendations

a. The 'governance vacuum' in most contract-based workplace pensions is one of the biggest long-term risks facing pension saving, and has the potential to undermine the Government's pension reforms. We believe this is a much greater risk than short service refunds, and should be the DWP's first focus.

b. If the DWP is concerned about the way Master Trusts are being marketed it should improve their regulation, rather than changing long-established rules on refunds and vesting for all trust-based schemes. There is a case for looking at the regulation of Master Trusts that are set up by commercial providers, to see if the current requirements are robust enough.

c. The Government should bring forward a consultation paper looking at different options for improving and encouraging transfers, in order to reduce the number of small pots. Solutions should be found to these issues before any changes are made to rules on vesting and refunds.

d. The DWP should wait to see what happens when auto-enrolment is in operation, and if there is any actual evidence of a serious problem, before rushing to impose new regulations and burdens on trust-based schemes. The Government should not make policy now based on assumptions about employer behavior that may not be true. A review of auto-enrolment is already scheduled for 2017 and this would be a sensible time to look at the evidence on refunds and decide if action needs to be taken or not.

Introduction

9. The NAPF is the voice of workplace pensions, both in the private and public sector. We represent 1,200 pension schemes, with some 15 million members and assets of £800 billion.

10. The NAPF and our members share the Government's objective of making auto-enrolment a success and extending access to workplace pensions. NAPF members operate all kinds of pension schemes including both occupational trust-based and contract-based workplace schemes. They are therefore well placed to comment on the regulatory differences between the two. Most NAPF members operate more than one pension scheme, with 91% operating an occupational DB scheme, 44% operating an occupational DC scheme, 37% a contract-based stakeholder scheme and 26% a contract-based GPP[4].

11. The differences between trust and contract-based schemes are complex, and employers operate different schemes for different reasons. The NAPF does not advocate one type of pension arrangement over the other, but we do believe that all pension schemes should have strong governance arrangements to make sure they are meeting members' needs.

12. This paper is divided into two sections. The first focuses on the regulatory differences between trust and contract-based pensions. The second focuses on short service refunds, and the impact that any change to the rules would have on NAPF members. The NAPF's recommendations are summarised at the end of each section. The details of our member survey are in the appendix.

[4] NAPF Annual Survey 2010, NAPF, March 2011.

Section 1: Regulatory differences

Comparing trust and contract based pensions

13. The Call for Evidence takes a very selective look at the regulatory differences between trust-based and contract-based pensions, focusing only really on one area: short service refunds. In reality, the differences between these types of pension provision are deep and complex, driven by an entirely separate history and legal status. NAPF members strongly believe that the document's failure to recognise these much deeper differences has driven it to focus on the wrong issues, and consider regulatory changes that could do great damage to high quality trust-based pensions.

14. The key difference between trust and contract-based pensions is the strong scheme-level governance that trustees provide. This governance provides significant benefits and protection for members. NAPF members report that the benefits of good governance in trust-based schemes include:

    - The ongoing monitoring and assessment of investment fund performance, with fund options removed if the trustees decide they are no longer appropriate.
    - The ability to review and improve the default fund, both for existing and future members.
    - An independent focus on keeping charges and costs low for the benefit of members. In 77% of trust-based DC schemes the employer either pays all charges or subsidises the charges for members[5].
    - Communications from a trusted source and tailored for the workforce.
    - Protecting and balancing the needs of both active and deferred scheme members.

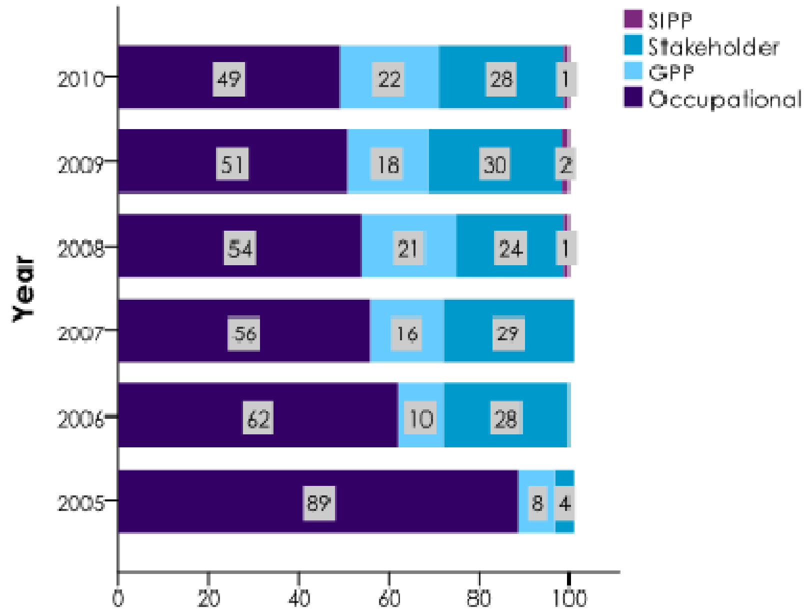
15. Contract-based provision can also have good scheme-level governance. Many NAPF members have chosen to introduce management committees, which take on many of the roles of trustees. These governance structures are recognised as good practice by the Pension Regulator and by the NAPF's Pension Quality Mark. However, they are purely voluntary and their use is not widespread except by very large employers. The NAPF believes the 'governance vacuum' in most contract-based workplace pensions is one of the biggest long-term risks facing pension saving, and has the potential to undermine the Government's pension reforms. We believe this is a much greater risk than short service refunds, and should be the DWP's first focus.

16. Providing this good governance through trustees has a cost for employers in terms of time and resource. Many employers have switched to contract-based provision, partly because of the greater flexibility this offers, with the ability to reduce the employer's governance

[5] Charging levels and structures in money-purchase pension schemes: Report of a quantitative survey, DWP Research Report 630, 2010.

responsibilities. Over the last few years the proportion of NAPF members whose main Defined Contribution (DC) scheme is trust-based has plummeted, as set out in Figure 1 below. In 2005, 89% of NAPF members said their main DC scheme was trust-based, but by 2010 that had fallen to 49%, with contract-based DC schemes being more common in the NAPF membership for the first time ever.

Figure 1: Main defined contribution scheme by type 2005-2010 (NAPF Annual Survey 2010)



17. This has been a long term trend, and we have not seen any significant evidence of it being reversed, with NAPF members switching back to trust-based provision. Therefore we do not accept the contention set out in the discussion paper that trust based pensions have a regulatory advantage that would encourage employers to pick them over contract-based pensions. The reasons for picking trust or contract-based schemes are complex. The DWP's recent research[6] confirmed this, as it found that pension consultants did not believe short service refunds were an important consideration for employers when selecting a scheme, and that most consultants did not think auto-enrolment would change this.

18. In fact, all the evidence suggests the advantage is in the opposite direction, and that as the regulatory burden of providing a trust-based scheme has increased, more and more employers have switched to contract-based provision.

[6] The use of vesting rules and default investment options in occupation pension schemes, DWP Research Report 725, 2011.

Master Trusts

19. There has been increased interest recently in 'Master Trusts', with new ones set up by pension providers and administrators. These are multi-employer trust-based schemes that are open to any employer to join. They are regulated by the Pensions Regulator in the same way as any other trust-based scheme, but do not have the same requirements for member-nominated trustees that apply to trusts sponsored by one employer or associated employers.

20. The Government has expressed concerns that some providers have marketed short service refunds as one of the benefits to employers of their Master Trust. We would share the Government's concern if employers were switching to Master Trusts to take advantage of refunds. However, there is no real evidence of this occurring. In fact, the experience of NAPF members is that the main target for operators of Master Trusts appears to be employers who currently operate 'unbundled' trust based pensions, rather than employers who already have contract-based schemes. Providers hope these employers might be persuaded that there are advantages to handing over much of the management and governance of their scheme.

21. The NAPF supports the development of more multi-employer trust based schemes. These could widen access to trust-based pensions to smaller employers, who might be unable to run a trust by themselves. They might also enable some consolidation in the DC market, which is very fragmented - 95% of schemes having fewer than 1,000 members[7]. Smaller schemes do not benefit from economies of scale and can find it harder to keep costs down and put enough resources into good governance and member communications. The NAPF has advocated not-for-profit 'Super Trusts' as the answer to this problem, but commercially-based Master Trusts could potentially have a role to play.

22. However, we can see there is a case for looking at the regulation of Master Trusts that are set up by commercial providers, to see if the current requirements are adequate. There are concerns about how independent the trustees are from the provider in some of these arrangements, and the DWP should look at whether rules need to be toughened up in these situations. Some Master Trusts, such as the Legal and General scheme, already include independent trustees. Making sure the regulation and structure of Master Trusts is robust is the best way of dealing with any concerns about the way they are being marketed, rather than changing long-established rules on refunds and vesting for all trust-based schemes.

Section 1: Summary of Recommendations

a. The 'governance vacuum' in most contract-based workplace pensions is one of the biggest long-term risks facing pension saving, and has the potential to undermine the Government's pension reforms. We believe this is a much greater risk than short service refunds, and should be the DWP's first focus.

[7] DC Trust, The Pensions Regulator, July 2009.

b.	If the DWP is concerned about the way Master Trusts are being marketed it should improve their regulation, rather than changing long-established rules on refunds and vesting for all trust-based schemes. There is a case for looking at the regulation of Master Trusts that are set up by commercial providers, to see if the current requirements are robust enough.

Section 2: Short service refunds

Current practice on refunds

23. The NAPF has conducted a survey of members with trust-based schemes to find out how common short service refunds are and the amounts being refunded. The research was conducted in early April 2011 and full details are in the appendix to this response. 74 NAPF members responded to the survey. 65% of respondents had an open trust-based DC scheme, 36% an open DB scheme and 14% a hybrid scheme**.** 89% of those who responded allow scheme members who leave after less than two years to take a refund. The survey found that on average 10% of members were eligible for a refund. The average refund was around £750.

24. When refunds are given, the employer's contribution is kept by the scheme. As the DWP's recent research[8] demonstrates, schemes mostly use this to subsidise the cost of running the scheme, by contributing towards governance costs, paying for advice, administration or communications. For many of the employers surveyed by the DWP the amount of retained contributions was not significant enough for it to have been put to any use. The DWP research demonstrates that it is not the case that refunds are mostly used to reduce employer contributions.

Support for keeping short service refunds

25. The survey also asked whether NAPF members supported keeping short service refunds. 87% of respondents said they wanted refunds to remain after the introduction of auto-enrolment. These respondents were then asked why they thought refunds should continue:

    - 95% believe refunds should be allowed as otherwise their scheme will be left with lots of small pots that are burdensome to administer.
    - 60% believe that their scheme is already having to deal with a lot of regulatory change and the Government should not be adding to this by changing the rules on refunds.
    - 53% are concerned that stopping refunds will increase the employer's costs.
    - 53% think refunds should be kept as they are popular with members who leave early.

[8] The use of vesting rules and default investment options in occupation pension schemes, DWP Research Report 725, 2011.

- 21% believe that their employer may decide to switch to a contract-based scheme if refunds cannot be made.

26. These results show just how concerned NAPF members are about the Government's proposal to remove or restrict refunds. The potential consequences are severe, with one in five respondents believing their scheme is at risk from closure. Where employers switch to a contract-based scheme their employees will lose the benefit of trustee governance. There is also the potential for employers to level down contributions to the auto-enrolment minimum when switching schemes.

Small pots and transfers

27. The two year vesting rule and short service refunds are a very practical and pragmatic way of allowing schemes to manage costs. The greatest concern of NAPF members is that if these rules are changed they will be left with the burden of managing a large number of very small pots that cost more to administer than they are worth. 95% of NAPF members who want to continue with refunds said the issue of small pots was a concern.

28. The Local Government Pension Scheme (LGPS) in England and Wales is a good example of what when a scheme stops short service refunds, and vests small pots from 3 months rather than 2 years, as they made this change in 2004. The result has been a surge in 'trivial' pots that will not provide meaningful benefits to members, but will drive up cost for LGPS funds for many decades to come. The local authorities involved are now urgently campaigning to get this change reversed. A survey of 64 LGPS funds found that in 3 years over 100,000 deferred pension pots had been created with benefits worth less than £2 a week. 56,000 of these tiny pots are worth less than £1 a week.[9]

29. The cost of administering a pension pot is the same regardless of its size. Many schemes outsource to Third Party Administrators (TPAs) who often charge a flat per-member rate – so every small pot that is not refunded or transferred adds to the administration cost. A typical large scheme would be charged £15 a year for each deferred member by their TPA. If the employee was in his or her 20s when he left that pot will need to be administered for 40 years before the pension is payable – a total cost of around £600. For a DB scheme this charge continues until the member and his or her spouse dies – increasing the cost to about £1,000. For DB and DC there is also a significant cost at retirement of facilitating the annuity purchase or calculating and setting up pension payments. Regardless of whether admin is outsourced or in-house or how the charges are structured by TPAs, in the end the costs of small pots falls either on the employer, or potentially on DC scheme members through higher charges. With the average refund being only £750 it's easy to see how for many of these cases the admin costs will exceed the actual value of the pension pot, meaning the burden on the employer and scheme outweighs any benefit to the member.

[9] Data collected by Kent Pension Fund and the Local Government Association.

30. Many NAPF members say they would like to be able to do more to encourage members with short service to transfer their pot rather than take a refund. Enabling employees who change jobs to combine small pension pots together, is essential for making the auto-enrolment reforms work. But the current system is very bureaucratic, with rules effectively preventing transfers unless the member takes full financial advice and fills in numerous forms. There are also obligations on trustees to make sure the pension that is being transferred to is legitimate, which also act to discourage schemes from promoting transfers.

31. If trustees were allowed to automatically transfer small pots this might help reduce the number of refunds. This would require a number of changes however:

- There would need to be a suitable destination for these pots. NEST would be the most obvious choice, but transfers are not currently allowed into NEST, and this new scheme should be allowed to establish itself before changes like this are considered. There is already a review planned for 2017.
- There would need to be changes to regulations to allow automatic transfers of small pots, with appropriate balance of safeguards for members and for trustees.

32. The issue of transfers and small pots is a big risk for the longer-term success of auto-enrolment. If the number of small pots proliferates, with most workers having multiple unconsolidated pots relating to different employments, then the costs of pensions will inexorably rise. This will hurt scheme members, employers and the industry, and ultimately reduce savings level and erode the benefits of auto-enrolment. This lack of efficiency, with members reluctant or unable to move between schemes, has been experienced in Australia since compulsion was introduced, and has helped prompt a major review[10] into improving the governance, efficiency and structure of the schemes there.

33. The NAPF believes that the Government should bring forward a consultation paper looking at different options for improving and encouraging transfers, in order to reduce the amount of small pots. Solutions should be found to these issues before any changes are made to rules on vesting and refunds.

Employee support for refunds

34. Over 50% of NAPF members who want refunds to continue, believe they should remain as they are popular with the members who get their contributions back. Some of those who get refunds may well be in financial hardship. For instance, workers with less than 2 years service have no statutory access to redundancy payments if they are laid off.

35. Some NAPF members believe that the existence of the refund option encourages take-up of their scheme by new employees who are uncertain whether they will stay with that

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[10] The Review into the governance, efficiency, structure and operation of Australia's superannuation system, Final Report, June 2010.

employer for long. They believe that the ability to get a refund can help convince the employee to join (or not opt out). Of course, many of these people will end up staying beyond 2 years and will end up greatly benefiting from their decision to join the scheme.

36. Therefore refunds can be seen as a simple and practical system of early access for some workers, and stopping refunds is not necessarily in the employee's interest. However, the NAPF does strongly support the aims of auto-enrolment, and believes the default assumption should always be in favour of pension saving.

Opposition to further regulatory change

37. Another strong view of NAPF members is that now is not the right time to consider further rule changes, when what employers and schemes want is certainty for planning how to introduce auto-enrolment. There is already a great deal of regulatory change in train (e.g. auto-enrolment, indexation, new tax rules, new targets on administration), and adding to that burden is not popular. 53% of those who do not want refunds stopped, believe that the current level of regulatory change means that the Government should not be considering further changes. The DWP should be trying to create certainty for employers and schemes trying to plan for 2012, not creating greater regulatory uncertainty by threatening to change more rules. The Coalition Agreement commits the Government to reducing regulatory burdens and reinvigorating occupational pensions, both of which are difficult to reconcile with proposals to change rules on vesting and refunds.

38. The DWP should not rush to make changes. Whatever the Government's decision, it is now clearly too late to bring in change to rules on refunds and vesting before auto-enrolment is introduced. Therefore, it makes sense to wait to see what happens when auto-enrolment in operation, and if there is any actual evidence of a serious problem, rather than make policy now based on assumptions about employer behavior that may not be true. This cautious approach is important because of the risk involved: Changes that could cause good quality trust-based schemes to close, should not be considered without real evidence that greater damage will be averted.

39. During the early phases of auto-enrolment the mandatory contribution levels are lower, and the amounts of money involved small, so the impact of refunds will not be great. Someone on average earnings who is receiving the minimum 1% employer contribution and making a 1% employee contribution on average earnings would have a pension pot of about £200 after 6 months, and could get a refund of less than £100. Even if an average employee left just before the two year deadline their pot is likely to be less than £800. Clearly, in many of these cases the lifetime admin costs are likely to be higher than the size of the pot.

40. A review of auto-enrolment is already scheduled for when the reforms reach steady state in 2017, looking at issues such as transfers in and out of NEST. This would be a sensible time to look at the actual evidence on refunds and decide if action needs to be taken or not.

Section 2: Summary of Recommendations

c. The Government should bring forward a consultation paper looking at different options for improving and encouraging transfers, in order to reduce the amount of small pots. Solutions should be found to these issues before any changes are made to rules on vesting and refunds.

d. The DWP should wait to see what happens when auto-enrolment in operation, and if there is any actual evidence of a serious problem, rather than make policy now based on assumptions about employer behavior that may not be true. A review of auto-enrolment is already scheduled for 2017 and this would be a sensible time to look at the evidence on refunds and decide if action needs to be taken or not.

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Appendix

NAPF Members Survey Results

1. The online survey was conducted in April 2011 with the link sent to all NAPF fund members. We had 74 responses from NAPF members with open trust-based schemes:

    - 65% operated an open trust based DC scheme
    - 36% operated an open DB scheme
    - 14% operated an open hybrid

2. 89% make use of refunds:

    - In the average scheme, 10% of members left before they had been in the scheme 2 years and so were eligible for a refund.
    - The average refund was around £750.

3. 87% of respondents with an opinion believe that schemes should be allowed to continue to give refunds after auto-enrolment has been introduced. These schemes were then asked why they thought refunds should continue:

    - 95% said that their scheme would be left with large numbers of small pots that would be burdensome to administer
    - 60% believe that their scheme is already dealing with large amounts of regulatory change and the Government should not be adding to this
    - 53% want refunds to be kept as they are popular with scheme members
    - 53% believe that refunds should be kept to stop employer costs rising
    - 21% believe that their employer might close the trust based scheme and move to a contract based scheme if refunds are stopped