Securing the future of pensions

Supporting Automatic Enrolment: A call for evidence on the impact of the annual contribution limit and the restrictions on transfers on NEST

The NAPF's response

January 2013

Overview

The NAPF strongly supports automatic enrolment and wants NEST to be a success. The pensions landscape has changed since NEST was established and it is right that restrictions on its operations are reviewed. The transfer restriction and annual contribution limit are just two restrictions on NEST, which also include its public service obligation. It is right that these other restrictions remain in place.

The NAPF believes that NEST should be part of any system for automatically transferring small pots and employers should also be able to bulk transfer into or out of NEST. While the annual contribution limit focuses NEST directly onto its core market, the NAPF does have concerns about its benefit in the medium to long term. The Government should remove the annual contribution limit in time for the automatic enrolment staging dates of small to medium sized employers.

The NAPF's recommendations are:

- NEST should be part of any system for automatically transferring small pots;
- Employers should be able to bulk transfer into or out of NEST; and,
- NEST's annual contribution limit should be removed.

About the NAPF

The NAPF is the leading voice of workplace pensions in the UK, speaking for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

Introduction

1. The NAPF strongly supports automatic enrolment, and believes that NEST is an important component of successful automatic enrolment. It is essential that NEST works efficiently and it is, therefore, right that the Department for Work and Pensions (DWP) reviews these restrictions.

2. The NAPF welcomes the work from across government and industry that has been undertaken on this issue. The Work and Pensions Select Committee, to which the NAPF gave evidence, has made a valuable contribution to the debate. The NAPF is pleased to be able to respond to this consultation and engage with the DWP more widely.

3. The economic landscape has changed considerably since the Pensions Act 2008, which introduced automatic enrolment and established NEST, was passed by Parliament. The number of multi-employer defined contribution (DC) schemes has proliferated, and there are now several low cost Master Trusts. These schemes are expected to play a bigger role in pension provision as automatic enrolment continues, and some will provide pensions for low to medium earners. But NEST has a unique role in the UK's pensions market due to its public service obligation.

4. The NAPF wants NEST to be a success. NEST should be an attractive automatic enrolment option for all types of employer. It is right, therefore, that the DWP reviews those constraints on NEST that may act as barriers to employers wanting to use it or for employees getting value for money. In principle, the NAPF does not believe that NEST should have unnecessary restrictions. But other necessary factors which limit NEST's ability to compete with other providers, such as its public service obligation to serve all employers, will remain in place.

5. The issue of NEST constraints must be seen in the broader context of current changes to the pension market. The DWP is currently exploring options for the automatic transfer of small pots, and the NEST constraints on transfers are part of this wider debate. While the NAPF has misgivings about the Government's proposed pot follows member solution for automatic transfers, NEST should be part of any system which is introduced. Pension transfers are not currently time or cost efficient, and it is important that both Government and industry continue to collaborate on improving the transfer process.

6. Ultimately, the UK has a very large number of DC pension schemes; there are around 46,000 separate trust-based schemes and over 100,000 contract-based schemes. In the future, the NAPF envisages pensions delivered at scale by a limited number of low charge, trust-based, not for profit schemes known as Super Trusts. These schemes will be well placed to deliver economies of scale and utilise substantial purchasing power on behalf of members. Transfers will become easier and less frequent if there are fewer schemes. In some cases there would be no reason for a transfer as individuals change jobs, for instance where both former and current employers participate in the same scheme.

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Transfer restrictions

7. As part of the settlement that established NEST, a restriction was placed on transferring into NEST. A restriction on transferring out of NEST was also incorporated into the NEST rules. It is right that the DWP is now reviewing those restrictions.

8. The NEST transfer restrictions should be seen within the context of wider Government policy objectives. In particular, the Government's decisions on NEST constraints should serve its desire to promote pension savings and deal with small pots.

9. According to its research, NEST's target audience will have a lower income than those currently saving into a pension scheme. NEST estimates that the median annual earnings of the target group are around £19,800 compared to £30,600 for those currently contributing to a pension. NEST's target group are more likely to build up small pots and should, therefore, be included in any automatic transfers system for small pots.

10. The Government consulted last year on dealing with small pots. In its response, the DWP confirmed that it would proceed with a system for automatic transfer of small pots. NEST should be able to participate in any system for automatic transfers.

11. The transfer restrictions also prevent employers from making bulk transfers into or out of NEST. This means that when an employer chooses to changes its automatic enrolment scheme from another scheme to NEST – or from NEST to another scheme – past contributions cannot be moved. This leads to a proliferation in the number of pots, and could mean that there are more small pots. This is likely to discourage employers from using NEST since their employees' savings could be effectively trapped. It also prevents other providers from competing for those savings already paid into NEST. In this way, removing the transfer restriction may increase competition and could impact on charges.

12. For the same reasons as above, there is also a case for allowing individuals to transfer their pension pots into and out of NEST. However, there is unlikely to be a large demand for member initiated transfers in the early stages of automatic enrolment so the DWP should prioritise lifting restrictions for other transfers. In the longer term, the DWP should consider how the transfer limit may impact on individuals approaching annuitisation with multiple pots in NEST and other schemes.

13. The timing of these changes will be especially important. These changes should be introduced in line with any proposals on automatic transfers to reduce complexity for employers and schemes. The restrictions on transferring both in and out of NEST should be removed at the same time.

14. More broadly, current processes for transferring pension pots are inefficient and costly for providers. The NAPF is working with Government and other industry bodies to improve transfer processes. There are a number of steps, such as using common discharge forms or online transfer protocols, which could improve these processes. It is essential that these inefficiencies are resolved as NEST is brought into a transfers system.

15. Therefore, we agree with the Work and Pensions Select Committee that the DWP should lift the restrictions on transfers. NEST should be able to participate in any system of automatic transfers and employers should be able to bulk transfer both in and out of NEST.

Annual contribution limit

16. NEST's annual contribution limit places a cap on the total amount that can be paid into a member's pot. In 2012/13, the annual contribution limit is £4,400. An individual earning £55,000 per year with total contributions of 8% on their entire income would reach this limit.

17. The annual contribution limit does ensure that NEST is targeted at its core market. It also fits with automatic enrolment rules since contributions may only be paid on earnings in the qualifying band, expected to be between £5,668 and £41,450 in 2013/14. Contributions of 8% paid on earnings in this band would not exceed the annual contribution limit. A member is also unlikely to reach the limit in the early stages of phasing contributions.

18. Nonetheless, the limit could cause additional complexity for some employers. Employers who have employees with a wide range of earnings may find that NEST is appropriate for lower earners but that higher earners would hit the limit. While larger employers will be able to segment their workforce into different schemes relatively easily, this may be more difficult for small employers. Instead, these small employers may have to use another provider or restrict contributions.

19. The NAPF has voiced concerns for some years about the risks of levelling down. This is where employers may reduce contribution rates to offset the costs of automatic enrolment. The NAPF's annual surveys have shown that many employers are still undecided on contribution rates for automatic enrolment schemes. Furthermore, a recent survey by Aon Hewitt found that as many as one third of employers with pension schemes could cut employer contributions. It is possible that the NEST annual contribution limit could encourage some employers to level down contributions.

20. The debate around the annual contribution limit should be seen in the wider context of contribution levels. The Pensions Commission predicted that paying contributions of 8% over 40 years would achieve an income replacement rate of 45%. In the future, the DWP may have to consider whether contribution rates for automatic enrolment schemes should be increased to achieve a higher income replacement rate.

21. Similarly, the DWP should consider how this change fits into the wider policy environment. The Government's *Reinvigorating Workplace Pensions* document considers auto-escalation of contribution rates to drive greater saving. This approach does not fit easily with NEST's annual contribution limit.

22. The NAPF believes that the annual contribution limit should be removed. Given the potential impact of this limit on small to medium sized businesses, the NAPF recommends that it be lifted in time for these employers' staging dates. However, the introduction of automatic enrolment is a period of considerable complexity for employers and schemes. Employers and the pensions industry need a period of stability without sudden changes to the automatic enrolment architecture. Thus, it is important that the DWP gets the timing of this change right.

23. The NAPF recommends that the annual contribution limit should be removed in time for small to medium size employers' automatic enrolment staging dates. This suggests a date in mid-2014. If removed by May 2014, employers with up to 159 employees would benefit from the change.

Questions

The supply side landscape

1. **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?**

Pension charges have fallen as automatic enrolment has been introduced, due to greater competition and the entry of low-cost providers into the market. Research by the Association of British Insurers has shown that the average member of a newly set-up automatic enrolment scheme will experience AMC of 0.52%. Older "legacy" schemes tend to have higher charges and average across pre-existing GPPs is 0.91%. The NAPF's annual surveys show that charges are falling. In 2012,the average AMC was 0.47% compared to 0.67% in 2011.

This has been especially pronounced in the early stages of automatic enrolment as larger employers meet their staging dates. But it is not clear that this decrease will continue. Indeed, charges may even rise as smaller employers look for automatic enrolment solutions.

The NAPF has contributed to the debate on charges by publishing the Joint Industry Code of Conduct on Charges. This document means that all charges will be disclosed and will increase transparency. The NAPF's Pension Quality Mark also promotes lower charges through its charge cap. NEST may have also contributed to the downward pressure on charges by providing a low-cost scheme.

Due to its public service obligation, it is likely that NEST will provide pensions for a large proportion of less profitable employers. Lifting the other restrictions will help NEST to maintain its appeal to a wider range of employers.

2. **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?**

Over the last several years, a number of low cost multi-employer schemes have entered the market. Some of these schemes can compete with NEST on charges. In many cases, schemes' providers have many years of experience in the pensions market, either in the UK or elsewhere.

These providers are unlikely to offer a pension for every single employer, so the market failure that led to the establishment of NEST persists. This means that NEST is likely to provide pensions for a high proportion of less profitable employers.

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

Yes. NEST is likely to serve a considerable proportion of low earners, and this group is the core target market of a system for automatically transferring small pots. NEST should be able to participate fully in an automatic transfers system.

Employer choice

4. What evidence is there that the annual contribution limit and the transfer restrictions placed on NEST are or will influence employers' decision making?

Employers may be discouraged from participating in NEST if they are unable to bulk transfer out. It would mean that they would be unable to secure a better pension scheme for their employee's existing savings should one become available in the future. It also prevents other providers from competing with NEST for those savings already saved in NEST.

It is possible that the annual contribution limit may impact on small employers with a largely low earning workforce but a small number of highly paid individuals. NEST may be a good choice for the majority of the workforce, but the annual contribution limit could impact on higher paid workers. However, these employers could resolve this situation either by segmenting their workforce into different schemes or using an alternative low cost provider.

5. Is there evidence of employers feeling unable to choose NEST for their workers due to the annual contribution limit and/or the transfer restrictions?

See above.

6. Is there evidence that employers (of any size) are prioritising or will prioritise a single scheme solution for automatic enrolment?

The NAPF's 2012 Annual Survey asked NAPF members about employers' plans for automatic enrolment. Two thirds (68%) of respondents had already decided which scheme to use. Of those, 45% of employers were planning to use a contract-based scheme and 40% a trust-based scheme.

7. 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?

The NEST restrictions may encourage employers to segment their workforce, which could increase costs.

8. **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?**

The transfer restrictions may lead to sub-optimal outcomes if small pots are not consolidated or where employers are unable to bulk transfer their employees' savings into a more suitable scheme.

The annual contribution limit may lead to sub-optimal outcomes if employers level down contributions to fit within the limit. However, this will not affect the core automatic enrolment target audience and employers may be able to resolve this by segmenting their workforce into multiple schemes; though this solution could increase costs for members.

NEST's investment strategies are designed to appeal to its target audience and it has a lower risk profile than some other schemes. These strategies may not be appropriate for individuals willing to accept greater risk.

9. **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?**

Employers should be able to uphold their employees' interests. This means that employees should be able to bulk transfer into or out of NEST to secure the best deal for scheme members.

Consumer interests

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

The Government's approach to the consolidation of small parts will be a key factor in protecting consumers' interests. The NAPF believes that small pots should be consolidated into low-charge schemes with good investment governance. NEST should be able to play a full part in consolidation of small pots.

As above, the NEST constraints should not prevent employers from upholding their employees' interests.

11. **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?**

The Government should avoid any risk of levelling down contributions as a result of the NEST annual contribution limit. This limit should be removed at the most practical point for employers and the pensions industry.

The Government may want to consider how NEST's charging structure, and particularly its 1.8% contribution charge, will apply to transfers. Applying the contribution charge to pots transferring in would be excessive. But it is also important to avoid large differences in charge levels between transferred pots and those pots originating in NEST.

Alternative approaches

Approach 1: Removing both restrictions altogether

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

Mid-2014 is an appropriate for the annual contribution limit to be lifted. The transfer restrictions should be lifted in time with the Government's timetable for automatic transfers. It makes sense that the restrictions on both transferring in and out of NEST are removed at the same time.

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

See above.

Approach 2: Enabling automatic transfers

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

Yes. NEST's target market is also the target market for automatic transfers. This group should not be excluded from the Government's small pots solution.

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

This is likely to be beneficial for individuals. Employers operating their own occupational schemes are likely to benefit if NEST is part of an automatic transfers system.

There will be cost implications for NEST and other providers, since removing this restriction will increase the number of transfers. However, removing the restriction will also lead to greater consolidation of small pots, with commensurate savings for providers.

Approach 3: Individual transfers

16. Should NEST members be allowed the same transfer rights as members of other occupational pension schemes, and if so from when?

This is desirable, but the DWP should prioritise bulk transfers and automatic transfers.

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

Lifting the restrictions on bulk transfers and automatic transfers are likely to have a greater impact on individuals and employers. Anecdotal evidence suggests that member-initiated transfers are currently infrequent so it is unlikely that lifting this restriction will result in a large volume of transfers.

Approach 4: Bulk transfers into NEST

18. Should bulk transfers into NEST be facilitated?

Yes.

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

Employers will be able to find the best deal for their employees. Individuals who have engaged employers are likely to benefit if this restriction is removed.

The removal of this restriction will likely make NEST a more attractive scheme for employers. Employers will be able to move members' savings out of NEST at a later date, rather than committing them to NEST with no guarantee that they can be taken out. Removing this restriction also means that there may be greater competition amongst providers for members' current savings.

Approach 5: The annual contribution limit

20. Are changes to the annual contribution limit required?

Yes. The annual contribution limit should be removed; the NAPF recommends that mid-2014 is a sensible point at which to remove this restriction.

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

Removing this restriction would be a substantial easement for small employers, who may have had to segment their workforce into more than one scheme. It also addresses the risk that some employers could level down contributions to enrol all employees onto NEST.

There may be greater competition amongst providers since NEST will now present a more attractive offer to some small employers.

All approaches

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

The transfer restriction and annual contribution limit should be removed. The transfer restriction should be timed so that NEST is able to participate in any automatic transfers system.

The annual contribution limit should be removed to best support small employers approaching their automatic enrolment staging date. The NAPF recommends that this restriction be lifted in mid-2014.

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

The NAPF's position is set out above.