Institute and Faculty of Actuaries

Ms Oxborough
Work and Pensions Select Committee
House of Commons
14 Tothill Street
London
SW1H 9NB

23 October 2014

Dear Ms Oxborough

**IFoA written evidence to the Work and Pensions Select Committee - Progress with automatic enrolment and pension reforms**

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to provide written evidence to the Work and Pensions Select Committee on the progress with auto-enrolment (AE) and the recent pension reforms. This response has been led by IFoA members who work with Defined Contribution (DC) pension schemes.

2. The IFoA is the chartered professional body for actuaries in the United Kingdom. Actuaries' training is founded on mathematical and statistical techniques used in insurance, pensions, fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies.

3. We have focused our evidence on those areas where our members have relevant experience and expertise. We would welcome the opportunity to discuss our response in more detail.

**Lessons learned from auto-enrolment implementation to date**

4. From a policy perspective, automatic enrolment's (AE) real innovation lies in its adoption of behavioural economics as a means to 'nudge' employees towards greater participation in workplace saving. The evidence so far suggests that capitalising on inertia can have a positive impact upon savings for retirement. However, AE is unlikely to be a pensions panacea, as it only addresses part of the broader retirement savings challenge. We would make a number of observations on AE implementation to date:

    a. Implementation of AE has generally been successful for larger organisations, where available resources can meet the systems and staffing requirements, or can pay for expert advice. Implementation for SMEs may not be as straightforward and this may have implications for opt-out rates.

    b. Now SME staging is underway, there should be close monitoring of where systemic complexities within the AE process may act as a barrier to SMEs achieving successful employee participation. In particular, the current eligibility criteria can appear complicated and the specific categories of employees - such as those who are younger, work part-time, or who are temporary or seasonal employees - can generate practical challenges for employers attempting to implement a successful AE programme. The staging experience of some larger organisations has illustrated the consequences of this complexity. For example, Limited Liability Partnerships (LLPs) initially assessed their partners as not eligible for AE, in accordance with their interpretation of the eligibility criteria. This interpretation was recently overruled by the recent Supreme Court ruling which pronounced that in certain circumstances partners in an LLP must be treated as workers, which requires the LLPs to enroll the affected partners, or face non-compliance with AE rules.[1] Whilst we would counsel against any retrospective changes that may create further work for those who have already implemented AE, we would support a review of AE rules in the interests of reducing complexity towards the conclusion of the staging process.

c. There is some evidence that, even where AE may improve income in retirement, individuals are choosing to opt out. In research co-sponsored by the IFoA, the Pensions Policy Institute (PPI) found the opt-out rate for over 50s to be relatively high at 15 percent, whereas, the average opt-out rate across all ages was 9 percent.[2] The PPI's report found that over 95 per cent of workers aged between 50 and state pension age were likely to receive good value from their workplace schemes. These findings suggest there is a need for further examination by the government of the reasons behind the higher opt-outs for this age category. In the interim, we would urge the government to consider the efficacy of its current communication campaign on AE and the extent to which it appropriately highlights the benefits for older people.

d. Whilst not a lesson from implementation so far, there is arguably a distinction between the policy approaches taken for accumulation and decumulation that the Committee should explore during its inquiry. AE has capitalised on the inertia that manifests in the face of complex financial decisions as a means of nudging people into saving for their retirement. However, at the point of retirement, a policy of 'freedom and choice' is founded on an expectation that people will effectively manage that complexity and take a proactive approach to financial decision making. As the first generation of auto-enrolled employees reaches retirement, it will be important that appropriate support is available to counteract the inherent inertia now that an annuity purchase is no longer the default option at decumulation.

**Issues arising from the extension of auto-enrolment to smaller employers**

5. While the evidence base for how smaller employers, particularly micro employers, react to the demands of AE will not be available for some time, the challenges we have noted in paragraphs 4 (a) and (b) above may require specific action. We would encourage the Pensions Regulator (tPR) to continue its proactive engagement with smaller employers and their representative bodies, with the aim of highlighting the challenges of successful AE, while simultaneously identifying potential actions to overcome them. In particular, the practical difficulties smaller employers face in not having the infrastructure in place to support AE, such as dedicated HR functions, budgets for new processes, or budgets to employ an adviser). TPR's support, and, where appropriate, intervention may serve to reduce the risk of small employers facing non-compliance.

**Progress towards implementation of automatic pension transfers**

6. The sheer scale of pensions reform in recent years has meant that employers and pension schemes have necessarily focused on AE implementation and delivery and, more latterly the

[1] Clyde & Co LLP and another (Respondents) v Bates van Winkelhof (Appellant)
[2] http://www.pensionspolicyinstitute.org.uk/publications/reports/automatic-enrolment-report-the-benefits-of-automatic-enrolment-and-workplace-pensions-for-older-workers

implications of the Budget reforms. We would welcome an exploration by the Committee on the extent to which this has impacted the priority given by firms and schemes to the planning for automatic pension transfer implementation.

7. What is clear is that the terms of any automatic transfer arrangement will not result in benefits for members if they lead to a shift of retirement savings to funds with higher charges; or to inappropriate investment strategies, that do not reflect members' risk appetites.

8. In getting implementation right for members, we would highlight two key considerations beyond the overarching need for automatic transfers to be member-appropriate:

    a. A proliferation of small pots can generate an unnecessary administrative burden. This may reduce the efficiency of scheme management, which would be a particular concern for trust-based schemes. In order to mitigate the risk of excessive bureaucracy, we would recommend a coordinated approach to the timing of the regulatory changes to abolish refunds from DC schemes and of the introduction of automatic pension transfers.

    b. We would also support the application of an appropriate kite-mark to illustrate that the default fund meets specific requirements as a precursor for an automatic transfer. If transfers were to take place, scheme members would benefit from a clear and timely communication strategy to ensure they are well-informed and aware of the option to opt-out if they were dissatisfied with the potential consequences.

**Progress with improving workplace pension governance and administration, including charge levels**

9. We welcome the DWP's approach to the introduction of the charge cap, especially the recognition of the actual administration and investment costs incurred in operating a scheme. It is welcome that the DWP has indicated what should be included in, and excluded from, the cap. The IFoA's response to the charge cap consultation suggested that disclosure of transaction costs to members may not provide many benefits, but trustees and Independent Governance Committees (IGCs) would benefit from understanding the impact of such costs.[3] As we noted in our response, while the focus on charges is welcome, the main impact of any legislative change should be to obtain good outcomes for scheme members.

10. The establishment of (ICGs) represents a means through which the governance of pensions can be improved. Our members have indicated that many firms are well positioned to make progress in establishing these committees and our anecdotal evidence suggests that this process has been helped by the publication of the draft guidelines in the FCA consultation on IGCs, (which some firms are using as a framework for implementation, in advance of the publication of final rules). Whilst it is impossible to know how IGCs will impact members, we would suggest that there are some overarching principles that should be followed in order to increase the likelihood of better outcomes:

    a. Good administration is critical to the successful management of any pension arrangement. Achieving this high standard requires promptness, accuracy and clarity of information for members.

[3] http://www.actuaries.org.uk/research-and-resources/documents/better-workplace-pensions-consultation-charging

b. Government faces a challenge in ensuring that costly administrative processes do not have a disproportionate impact on the members, through higher transaction costs. IGCs (and trustees of trust-based schemes) may usefully ensure there is an appropriate balance between good quality administration and fairness in costs for members.

c. The primary focus should be on ensuring value for money, rather than simply participating in a race to the bottom in terms of charges.

d. There are various accreditations for pension schemes (e.g. NAPF Quality Mark, ISO 9001). We would encourage schemes and service providers to achieve these accreditations.

e. There are specific considerations for legacy schemes. We would welcome clarification in how those schemes, with significant Active Member Discounts (AMDs), or pre-2001 policies with charges, can be successfully incorporated into the new system.

f. In some cases, there are significant regulatory barriers for employers consolidating their DC arrangements, without requiring individual member consents. The IFoA would welcome the opportunity to discuss this specific barrier, which had been written with Defined Benefit (DB) schemes in mind, with the Committee.

**The changes to pension taxation arrangements announced in Budget 2014, including the ending of the requirement to annuitise**

11. It is clear that there is potential for the new flexibilities to provide good outcomes for many members, reflecting the specific circumstances they face during their remaining lifetimes. Nonetheless, we would also emphasise that 'freedom and choice' brings with it the possibility of some unintended consequences that require further consideration:

    a. Increasing choice for retiring members may result in some of those members making decisions that do not reflect their specific income needs for older age and may lead to them having insufficient money over the full course of their retirement.

    b. The terms of statutory override regulations need to be clear and avoid potential unintended consequences. Depending on the wording of the statutory override, there are potentially significant cost implications for schemes. This is because an override might enable members with a DB and a DC entitlement, in the same scheme, to benefit from taking all their tax-free cash from the DC pot (rather than pro rata from each). This decision may be detrimental to the finances of the scheme as a whole and, consequently, to the sponsoring employer. Further, if the override were to require costly IT developments, it may be significantly more costly and disruptive than encouraging movement to new schemes. While the cost burden of meeting the override may initially fall on scheme providers or administrators, it is likely that scheme members may ultimately pay the increased cost.

    c. The increased flexibility, to a greater or lesser extent, will also affect employers, trustees and product providers. We have tried to capture these issues throughout our response. Financial dependents may also be subject to altered financial circumstances because of decisions taken by scheme members.

12. Individuals may under-estimate their expected longevity - and the potential variance in that longevity. Consequently, some individuals may have insufficient savings to provide income, particularly in the latter stages of life. Alternatively, others may take a very cautious approach to reducing their funds, due to over-estimating their life expectancy, and may leave significant funds at death. Actuaries have significant expertise in analysing mortality experience and understanding the difficulty in predicting life expectancy. We would welcome the opportunity to discuss the key factors affecting longevity in greater detail.

13. We would encourage the development of a comprehensive approach to guidance, which provides appropriate support for all members of pension schemes, both occupational and individual. Obtaining information should not be at a single point-of-time event, but should be undertaken at critical points in the lead up to, and after, retirement. Guidance should cover all the options available under the new flexible regime, ensuring customers are aware of all potential outcomes (and risks) of their decisions, along with the taxation consequences of exercising those options.

14. We would welcome research by the Government on appropriate default frameworks for schemes. Consideration could be given to requiring schemes and providers to put in place an appropriate default decumulation vehicle, analogous with AE requirements.

15. Any such vehicle would need to meet minimum standards that are likely to include capped charges and flexibility to allow an active choice at a later date. It might also include the option to annuitise at a later age, when longevity risk pooling becomes more important and outweighs the perceived reduction in value, due to the cost of providing a guaranteed income within regulatory requirements.

16. If fewer people elect to purchase annuities at historic retirement ages, current investment strategies, particularly default strategies, may no longer be appropriate, as they were designed for most individuals purchasing annuities. While individuals draw on capital and income from their accumulated funds, they must be aware of the risk and reward consequences of investment decisions about their pension assets. While the funds remain invested, individuals will be faced with a series of investment decisions. It has traditionally been challenging to engage members to plan for periods of around fifteen years, but the need to consider the longer term impact of retirement decisions will be challenging for many scheme members. Therefore, it is much more difficult to assess which retirement income mechanism; annuity, drawdown or withdrawal, would be the most appropriate and which would be appropriate at what time.

17. Historically, drawdown has been an advised product. If this is no longer the case, it is not clear whether there is scope for providers to supply a sufficiently robust non-advised product. It also remains unclear whether the Guidance Guarantee would be able to deliver on the potential scale required.

**The trend towards extended working lives.**

18. Currently, a significant number of those reaching retirement will have participated in a DB scheme for at least some of their working lives. The need for an adequate DC default decumulation mechanism will increase over time, as more retirees have been members of a DC scheme for longer and will have built up significant funds by the time they reach retirement.

19. Given the lower level of contributions to DC schemes, lower investment returns and the increase in longevity, it is likely that DC schemes will not provide the same level of retirement income that DB schemes provided. As the proportion of the population will be relying only on pensions from DC sources, there will likely be an impact on the timing of retirement decisions - as a result of lower incomes than previous generations. This may lead to a delay in retirement ages, with an increase in either full or part time work.

20. The new retirement freedoms introduced in the 2014 Budget should make it easier for members to work longer. Early access to their pension pot will be possible and it will be more straightforward to defer full retirement to a later date. Whilst this was possible under the old legislative environment, it was not as easily accessible with members taking full retirement to access their accumulated pension assets.

21. The trend towards extending working lives should be considered alongside one of the other key policy challenges presented by population ageing: long term care. Policy makers face a significant dilemma in legislating to reflect increasing longevity (such as increasing the state pension age) and addressing the challenge of long term care needs. Research has shown that the fastest growing age group within the population is people aged over 85 years but, whilst life expectancy is increasing, healthy life expectancy is not increasing at the same pace.[4] There is, subsequently, a large proportion of the population over 85 who currently rely on their children, many of whom are nearing retirement age to provide long term care and support. The Government must consider how labour market activation approaches and policies to extend working lives might impact upon the availability of familial care provision and, subsequently, state-funded social care services.

22. If you wish to discuss any of the points raised please contact Philip Doggart, Policy Manager (philip.doggart@actuaries.org.uk/ 01312401319) in the first instance.

Yours sincerely,

Gareth Connelly
Chair, Pensions Board
**Institute and Faculty of Actuaries**

[4] Jagger C, Collerton J, Davies K, Kingston A, Robinson L, et al. (2011) Capability and dependency in the Newcastle 85+ cohort study. Projections of future care needs. BMC Geriatr 11: 21.