The Actuarial Profession
making financial sense of the future

Consultation Response
Department for Work and Pensions

Meeting future workplace pension challenge:

improving transfers and dealing with small pension pots

23 March 2012

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

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 – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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23 March 2012

Dear Natalie

Department for Work and Pensions: Meeting future workplace pension challenge: improving transfers and dealing with small pension pots

On behalf of the Institute and Faculty of Actuaries (the Actuarial Profession), we welcome the intended objectives of the above consultation. The ability for people to manage all of their accumulated pension savings appropriately is extremely important and we are grateful for the opportunity to comment on the questions asked in the consultation. This letter outlines the response of the Actuarial Profession from the committees representing our Life and Pensions practice areas.

General Comments

We have only included answers to the questions where we feel the Actuarial Profession can provide a particular viewpoint. For many of the questions where no response has been provided, we feel that other parties, such as pension providers, the ABI or NAPF, may be better placed to comment.

We would also like to bring to your attention the following general comments, some of which cut across several of the proposed options in the consultation document:

- We would like to emphasise the importance of cost management in any proposal. We would suggest that understanding the true cost of running an aggregator scheme for pension pots of this size or managing the transfer of small pension pots between employers is crucial to making an informed decision on this subject.
- Costs need to be understood from the perspective of the pension provider as well as the consequences for charges on the members' pension funds. For the majority of defined contribution pensions, there is no separate pot of money set aside to pay for charges. Any additional expenses will ultimately be met from members' pension pots.
- We would also like to draw particular attention to the potential impact on investment returns to the members. Where small pension pots are being transferred automatically to new employers'

schemes or an aggregator scheme, there is a risk that the members' pensions do not generate the same level of investment returns as they may have done in their original investment funds, as a result of an action taken by a third party.

- While the proposal to hold a central database to match members to their pension pots may ultimately help with consolidation on small pension pots, we would encourage thorough thinking on what the central database will actually need to do. We would suggest that it needs to go beyond just holding data and may need to act as a controlling mechanism for transfers between schemes.
- In aggregate, across pension scheme members with small pots as a whole, we believe that some of the proposals will deliver against the guiding principles for reform. However, care needs to be taken over how some of the proposals might impact certain individuals. For example, there may be individuals who do not benefit, or who are worse off, from the proposals, perhaps challenging the principle of fairness. We would urge further analysis by Government to better understand the potential consequences for all individual members and not just in aggregate.

Specific Responses to Consultation Questions

Our specific responses to the questions listed under Chapter 7 of the consultation document are as follows:

2. Do you agree that these are the current barriers to transfers?

We agree with the list of barriers already outlined in paragraph 38. In addition to the supply-side barriers documented, we would also suggest including the fact that some schemes might not accept transfers without evidence of advice to members, as mentioned elsewhere in the consultation document. Further to this, some schemes may be unwilling to accept certain types of transfers, such as those with unequal guaranteed minimum pensions (GMPs), as the scheme may not want to accept responsibility for equalising the GMPs later (although this may not be an issue if automatic transfer does not encompass DB schemes).

3. Would any or all of the proposals under this option be an effective way to facilitate more transfers and reduce the number of small pension pots?

The first and fourth bullets under paragraph 61 may have the potential to contradict each other. We are supportive of encouraging individuals to initiate transfers through providing them with the right information to make informed decisions. However, suggesting that costs could be reduced by withdrawing benefit statements, in addition to the current option of not issuing benefit illustrations, may risk being at odds with this objective. We would encourage Government to think carefully about the minimum information that consumers require to be able to transfer and consolidate their pension pots, balanced against the need to keep administration costs down.

5. Taking account of our principles for reform, which of the two models in Chapters 5 and 6 do you think has the most merit?

We feel there are three particular principles where the aggregator model (Chapter 5) and the model of moving pension pots from job to job (Chapter 6) could be differentiated:

- **Fairness**: There could be higher variability, and possibly complexity, of charges amongst employer schemes compared to that of an aggregator scheme.
- **Simplicity**: Where an individual leaves employment for a period of time or has multiple jobs, the model in Chapter 6 may not be as simple as the aggregator model and could require more input from the employee.
- **Ease administrative burdens**: The need for employers to track down previous pension pots for new staff and transferring out pension pots for leavers, under the Chapter 6 model, would seem more complex than employers just dealing with one aggregator scheme for all leavers. Also, if the individual is changing from a trust-based arrangement to a contract-based arrangement (eg personal pension), or vice versa, there could be additional administrative complications with the model in Chapter 6.

While the models proposed under Chapters 5 and 6 are not without their practical challenges, the aggregator model in Chapter 5 would seem to be more amenable to the guiding principles for reform.

7. Although the solutions in this paper deal with small pots in DC schemes, we would be grateful for views on how defined benefit (DB) schemes should be treated and whether we should also consider applying any transfer solution to DB rights?

There may be advantages in extending any proposals to cover Cash Transfer Sums for leavers from DB schemes with less than two years service (providing the scheme does not offer deferred pensions for such leavers). However, automatic transfer of small DB deferred pensions to DC pots would need to be considered very carefully, particularly in the context of transfer value calculations and in terms of how to square automatic transfer from DB to DC with the Government's views on the advisability of ETVs. Further, care would be required in relation to the equalisation issue referred to under question 2.

8. Do you agree that under an automatic transfer system, members should have the right to opt out?

Yes. However, we recognise that it may be difficult to implement fully in practice. For example, schemes will need to ensure that individuals receive the required opt-out information in a timely manner to allow them to exercise any opt-out prior to the transfer taking place. Individuals changing addresses or going abroad are examples of when there could be an increased risk of the paperwork not being received in time for an opt-out. To some extent, members with small pots may also be the group for whom data held is most patchy (because they have less incentive to inform the administrator of any changes), so this issue might be more significant than would otherwise be expected.

Individuals may also assume that if they do nothing, their pension pot will remain where it is (the current default) and may not realise that an automatic transfer system is in place. We would encourage such a transfer system to be accompanied with sufficient communication to all (existing and departing) members to ensure they understand what will happen if they take no action in the event of them leaving employment.

9. Do you agree that individuals should not be required to take advice in an automatic transfer system, provided sufficient safeguards are put in place?

In principle, we would agree with this proposal and note that many work-based schemes currently accept transfers on an "execution only" basis, where no evidence of advice is required. We would suggest Government ensures that this process is accepted by the FSA as absolving the receiving scheme from any obligations under FSA rules in this respect.

10. Do you agree that solutions to address the expected rise in small pots after automatic enrolment should also be designed to take account of the existing stock of small and dormant pension pots?

Yes, although we recognise that there could be a number of practical limitations, particularly where the owners of the pension pots are untraceable. This could be a particular risk for trust-based pension schemes, where the pension provider (for example, a Life & Pensions company) might not hold individual addresses for each customer.

Similar to question 8, we would also urge Government to consider how this will be communicated to individuals and highlighting to these individuals what this might mean for the chosen investment funds of the pension pot. The risks of limited data and members not understanding that the system is changing (see our answer to question 8) may also be greater for members with dormant pots.

11. What are the particular challenges and benefits created by introducing one or several aggregator schemes?

A key area that we feel needs to be better understood is the importance of cost management in any proposal. Administering small pots in a cost effective way is one of the biggest challenges and we would suggest that streamlined processes have an important part to play in this.

Another area that will require careful consideration is the choice of investment fund for any aggregator fund and the extent to which individuals may make any investment choices. There is a risk that the investment return on the aggregator fund could be considerably less than if the customer had remained in the same funds as their original pension pot (indeed, it could also be considerably more, but this is less of a risk). While the investment approach might be considered "appropriate" at the time, the true extent of this might only be known with hindsight and Government may need to accept that there will inevitably be winners and losers in terms of returns achieved in the new fund compared with those which would have been achieved if no transfer had been effected.

Finally, we would suggest that full consideration is given to the likelihood of errors arising in managing the transfers into the aggregator scheme(s). Some errors could equally apply to the option outlined in Chapter 6. Such errors would include:

- Pot transferred to a new scheme when it should not have been (as a result of misidentification of the member by the transferring scheme, receiving scheme or central database)
- Pot not transferred when it should have been
- Pot transferred at an inappropriate time such that investment losses occur
- Pot transferred to "wrong" aggregator (if there is a system of multiple aggregators)
- Wrong amount credited
- Member complains that he would have opted out of transfer if he had been notified and he/she says that he was not properly notified - or that he did opt out but the opt out was ignored (and this led to a reduced investment roll up)
- Member complains that he would have chosen an investment other than the default if he had been notified of an option to do so and he/she says that he/she was not properly notified - or that he/she did so elect but the election was ignored

Any of these examples could lead to customer detriment. We would suggest that it will be important that responsibility for leading the correction of any errors and paying any compensation is understood in advance.

13. Could the pensions industry offer an aggregator scheme with these characteristics?

We feel the pensions industry could offer an aggregator to the extent that the financials make it viable. We suggest that there is also a need to consider the impact on members of such an industry-led scheme. Chapter 6 contains (in 6.2) an assessment of the impact on members and we would suggest a similar impact is considered in relation to Chapter 5. This could consider the following:

- Impact of change in charges – it is possible that a realistic annual management charge for this type of portfolio might be nearer 5% pa rather than 0.5% (because of the small average pots to which they would be applied)
- Impact of transfer costs, including any bid/offer spread on selling assets in the existing investment fund and buying assets in the aggregator's investment funds
- Impact of the member moving into a different investment fund that could potentially perform less well than their original investment fund.

15. Should there be several aggregator schemes or one?

It is possible that the introduction of several aggregators could introduce further complexity and also confusion for individuals seeking to track down old pension pots.

We also note that if there are to be multiple aggregator schemes, rather than a single aggregator, there could be an additional step to identify the "correct" aggregator scheme and then allocate and instruct the transfers to that scheme. i.e. there will be a need for a mechanism to ensure that transfers are controlled and instructions are passed between parties. We would suggest that such a mechanism has the potential to add an additional cost to any transfer process. There would also be more potential for member detriment and complaint if members could (with hindsight) compare funds in relative aggregators and argue that the wrong one was chosen for them.

19. Given the default nature of the transfer, which of the member, the transferring scheme or the aggregator scheme should pay the default transfer costs?

We would like further information on how Government envisages the transferring scheme or aggregator scheme paying for the default costs in practice. Given how current DC pension schemes operate and the models described in the document, there would be no separate pot of money set aside to meet such costs. All assets are part of the members' own pension pots. Even if the transferring scheme or aggregator scheme meets the costs, it would ultimately be passed on to members, who will pay for it implicitly through ongoing charges. This means that the members will pay for the default transfer costs but probably with a significant degree of cross subsidy between members who change employment frequently and those who change less frequently.

20. Are the existing protections for individuals sufficient for this option where pensions follow people from job to job?

Similar to the points already raised under questions 11 and 13, consideration should be given to the extent to which a member's pension pot could be subject to:

- Different, and potentially higher, charges when their pension pot moves to the new employer's scheme.
- Different investment funds that may deliver poorer returns than the original investment funds.
- The impact of any transfer costs

In protecting member interests, the mechanism for moving the pension pots between employer schemes will be important, as will the extent to which this is controlled appropriately.

We would also suggest that member communication is crucial and considerations for individuals with multiple jobs must be made clear; for example, to which employer would an existing pension pot move?

21. Should a pot size maximum be applied to pension pots that are automatically transferred? If so, what should the maximum be?

Other parties would be better placed to comment on the size of pension pot. However, we would urge Government to review any maximum size of pension pot on a regular basis and consider whether any revised maximum should apply to new leavers or all existing pots (the latter spurring a peak in transfer activity each time the maximum is reviewed).

22. How could a central database successfully match members with their pension pots?

The suggested data items under paragraph 124 would seem like a good starting point for such a database. We would suggest that the database should also be able to cope with historic personal addresses, employer/scheme history for an individual, multiple employers at the same time and any historic name changes. Historically, some pension schemes have encountered a number of issues with National Insurance numbers and have been known to employ “dummy values” where the National Insurance number is not available. Quality of data will underpin the success of any database.

We are also assuming that such a database would comply with Data Protection laws with regard to storage and usage of the data.

We would also like to re-iterate that the central database also needs to be able to control the transfer mechanism, rather than just being a pure depository of data.

24. What should happen to pots when an individual does not join an employer for a long time?

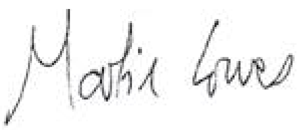
Under the model described in Chapter 6, we would broadly support the suggestion in paragraph 127, recognising some of the practical difficulties identified in our previous answers.

25. What should happen to an individual’s older dormant pension pots in this proposed process (those pots in DC schemes), where pensions follow people from job to job?

Where feasible, we would suggest consolidation of those pension pots as far as possible to allow the individual to benefit from better cost efficiencies and potentially more choices for retirement income when they reach the decumulation stage. We do, however, recognise that there could be a number of practical difficulties with this proposal, particularly for scheme-initiated transfers. We think there is the potential for better outcomes with member-initiated transfers. However, we would suggest a significant degree of member engagement activities to support this.

We hope our contribution will be helpful as you seek to manage the future of small pension pots. If you have any questions about our response or would like to discuss any of the above points in more detail, please contact Kirstin Lambert at the Actuarial Profession, on telephone number 0207 632 2168 or e-mail Kirstin.Lambert@actuaries.org.uk.

Yours sincerely,



Martin Lowes

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