Institute
and Faculty
of Actuaries

Pensions Automatic Enrolment

IFoA response to the Work and Pensions Select Committee

3 February 2016

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.

Institute and Faculty of Actuaries

Rt Hon Frank Field MP
Chair, Work and Pensions Committee
House of Commons
London
SW1A 0AA

3 February 2016

Dear Mr Field

IFoA response to Pensions automatic enrolment inquiry

1. The Institute and Faculty of Actuaries (IFoA) welcomes the Committee's inquiry into automatic enrolment (AE) and in particular that the terms of reference include the relationship between AE and other pension reforms. We have seen an unprecedented fundamental shift in pension policy with the introduction of AE and the pension freedoms, and therefore, a holistic perspective of the current pension policy environment and what it means for current and future pensioners is timely and important.

2. The IFoA is the UK membership body for actuaries, many of whom work in and have a statutory role in the supervision of pension schemes and life companies. As a Royal Chartered professional body, we harness our members' expertise to inform economic and social challenges in the public interest. We have only commented on those aspects of the inquiry where we have undertaken research or analysis.

Executive summary

3. To date AE has been successful in increasing the number of people saving into an occupational pension. To build on this momentum, immediate focuses for the Government should be:

    - Conducting a holistic analysis of the pension policy environment and what it means for current and future pensioners

      Due to recent pension reforms and trends in pension provision future, retirees will increasingly have defined contribution (DC) rather than defined benefit (DB) pensions and have access to their pension from age 55 with no requirement to purchase an annuity. It is important that we try to understand what retirement will look like for future retirees to assess whether the pensions framework is effective in helping individuals to achieve an adequate income throughout their retirement.

    - Monitoring of, and, if necessary, appropriate intervention in, the staging of AE to SMEs

SMEs, and in particular micro-employers tend to have less awareness of AE since many will not have previously offered any kind of pension scheme. Additionally, if the employer does not approach NEST, there is no guarantee that the pension provider they approach will take them on. Close monitoring and appropriate intervention to address any problems identified with the AE process will help to ensure SMEs successfully enrol their employees.

It will also be important to monitor those opting out and their reasons for doing so. This is to ensure any trends are identified early and to explore whether any remedial action is required.

- Increasing levels of saving

  With the roll out of AE and the increase in minimum contribution rates completing in 2019, it is timely for Government to identify any cohorts that are at risk of a savings gap and be thinking about strategies that build on the momentum to date to encourage a greater level of saving, whether that be increasing contribution levels or encouraging auto-escalation.

The interaction between AE and other pension reforms, including the new state pension and pension freedoms

4. The IFoA welcomes that the Committee's Terms of Reference includes the relationship between AE and other pension reforms. We recommend the Government undertakes a comprehensive review on the impact of the recent changes to State, occupational and private pensions for both current and future retirees. Whilst AE is increasing the number of people saving into an occupational pension, it is important that the pensions framework as a whole supports individuals in achieving an adequate income that lasts for the duration of their retirement. The comprehensive review should help Government to reach a new agreement for pensions that prevents, as far as possible, a continuation of the constant tweaking to the system. Stability in the system could help to build trust that pensions provide a transparent and sustainable savings vehicle.

5. In this new environment we believe one of the key challenges for individuals will be in understanding the implications of longevity risk and that without support to do so they may become unable to meet their daily financial needs in later life. The pensions framework must, as far as possible, help to equip people to mitigate this risk if those in the later stages of retirement are to be protected from running out of funds. The framework should support individuals to:
   - understand their retirement income needs;
   - assess their likely income against potential expenditure (including future long-term care needs);
   - understand how long they might live for, and therefore, how long their savings might need to last (not just their life expectancy, but also the likelihood of living to much older ages);
   - save to meet their income needs; and
   - make informed decisions about how they spend their savings throughout the duration of their retirement, for example, how financial products might help individuals to mitigate longevity risk.

Furthermore, as pensions require long-term financial planning the pensions framework must be sustainable for the State, savers and employers in the long term, with clarity on the role of the State.[1]

6. We have, in conjunction with the American Academy of Actuaries and Institute of Actuaries of Australia published 'The Challenge of Longevity Risk: Making Retirement Income Last a Lifetime'. In this paper we identify five principles for mitigating longevity risk:
   i. Adequacy
   ii. Information
   iii. Flexibility
   iv. Equity
   v. Sustainability[2]

7. Our intention is to complete further work on each of these five principles and we are in the initial phases of a research project that will:
   - review existing measures of adequacy in light of the evolving DC environment;
   - set out to develop new measures; and
   - use these measures against population data to identify those most at risk of having an inadequate income in retirement.

   We would welcome the opportunity to meet with the Committee as this work evolves to discuss it in further detail.

8. We would also like to highlight to the Committee the need for DWP to publish its transitional guidance on the new 'cost of accruals' test for contracted-out DB schemes as early as possible as they will need to act before 6 April to ensure their schemes remain qualifying for AE.

9. Finally, we would ask the Committee to consider the different treatment of those earning less than the personal allowance threshold by relief at source and net pay schemes as well as the implications for higher earners. Whichever type of scheme an employer chooses it is important that they are aware of the implications for their employees. We appreciate this situation may change dependent on the announcements in the 2016 Budget.

The effectiveness of the AE process and lessons learnt so far

10. 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. However, implementation of AE is not straightforward. The complexities, time and cost to implement AE could be significant for micro-employers and this may have implications for opt-out rates. Now that SME staging is underway, there should be close monitoring of those who are opting out as it may identify systemic complexities within the AE process that are acting as barriers to SMEs, and in particular micro-employers, achieving successful employee participation.

11. Close monitoring will also identify behavioural trends and allow early remedial action where it is required. IFoA co-sponsored research by the Pensions Policy Institute (PPI) has highlighted one such trend. The research found the opt-out rate for over 50s to be relatively high at 15

[1] IFoA (2015) Policy Briefing: Saving for retirement (http://www.actuaries.org.uk/documents/saving-retirement-policy-briefing)
[2] IFoA *et al.* (2015) The Challenge of Longevity Risk: Making Retirement Income Last a Lifetime (http://www.actuaries.org.uk/documents/challenge-longevity-risk-making-retirement-income-last-lifetime-0)

percent, whereas, the average opt-out rate across all ages was 9 percent.[3] The PPI's report found that over 95 percent of workers aged between 50 and state pension age were likely to receive good value from their workplace schemes.[4] 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 need for those people to consider their retirement income needs, particularly those approaching retirement.

12. From a policy perspective, AE's 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 saving for retirement. However, AE only addresses part of the broader challenge of promoting the adequacy of retirement income. There is tension between the behaviours promoted by the AE reforms and the behaviours likely to arise from the freedom and choice agenda that the Committee should continue to explore during its inquiry. As a first step to achieving this we recommend a joint Government and industry approach to collecting data on how people are responding to the new system to assess whether education, access to information, guidance and / or advice, the use of defaults or incentives such as tax relief influence people's decision-making. This should capture those approaching, at the point of and throughout their retirement as it is important to understand how people are making decisions into the latest stages of retirement.

13. This will be important in the long term, but for those auto-enrolled employees that are already reaching retirement, it is important that appropriate support is available to counteract the inherent inertia. As the FCA's Thematic Review of Annuities highlights, inertia can also lead to poor outcomes where the path of least resistance does not lead to the best outcome.[5] There is a risk that the easiest option for savers may be to take their DC pot as a lump sum and this is unlikely to be optimal in most cases as a means of helping savers to fund their future retirement income needs.

14. We therefore also recommend that the Government conducts research into what arrangements might be put in place to ensure that inertia nudges savers in a direction that is likely to be appropriate and that schemes ensure their default framework best supports appropriate outcomes. The form that this might take is beyond the scope of this response, but consideration could be given to requiring schemes and providers to put in place an appropriate default decumulation vehicle, analogous with AE requirements. The IFoA is completing research on both nudges and default pathways and would welcome the opportunity to discuss to discuss these with HM Treasury.

The suitability of the AE minimum contribution rates

15. The total minimum contribution level will now not reach 8 percent of qualifying earnings until 1 April 2019. We urge the Government not to delay this further as it is important that workers begin to build up the level of pension savings they will need for an adequate income in retirement and the Government risks causing confusion amongst members whose schemes had already sent out communications about these planned increases.

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[3] Pensions Policy Institute (2014) The benefits of automatic enrolment and workplace pensions for older workers

[4] Good value is defined as expected rate of return on pension contributions, above the benchmark investment return of 6%, including taking account of the effect on means-tested benefits and taxation.

[5] FCA (2014) TR14-02 Thematic Review of Annuities

16. We recommend that should the Committee review the minimum contribution rates it should not do this without giving further consideration to what an adequate income in retirement would look like. The widely used replacement rates from the 2004 Pensions Commission Report do not account for actual income needs, which individuals will need to increasingly engage with owing to the shift from DB to DC and the implementation of pension freedoms. For those individuals where their AE contributions and any State benefits do not match their expected retirement income needs it is important they understand the potential gap in their savings and are encouraged to save to meet their needs.

17. In addition, AE does not capture all of the working population, for example, low-paid workers, including those with multiple low-paid jobs and the self-employed. Under the current system these groups will not be able to benefit from AE. It is important these groups are not ignored and future developments give greater consideration to how these groups might be incentivised to save for their retirement.

18. With the roll out of AE and the increase in minimum contribution rates completing in 2019, it is timely for Government to identify any cohorts that are at risk of a savings gap and be thinking about strategies that build on the momentum to date to encourage a greater level of saving, whether that be increasing contribution levels or encouraging auto-escalation.

Should you wish to discuss any of the points raised in further detail please contact Rebecca Deegan, Policy Analyst (rebecca.deegan@actuaries.org.uk / 02076322125) in the first instance.

Yours sincerely,

Nick Salter
Immediate Past President, Institute and Faculty of Actuaries