Meeting Future Workplace Pension Challenges

Response to DWP consultation paper on improving transfers and dealing with small pension pots.

Overview

Independent Trustee Services Ltd welcomes the opportunity to consult on the issue of dealing with small pension pots. As trustees we are obviously concerned to ensure that all members for whom we are responsible are treated fairly. At the same time we are acutely aware of the practical difficulties in keeping track of deferred members, often with 'small' pots, where the member is less likely to be actively engaged with the Scheme and where the trustees are frequently left in the onerous position of making investment decisions in terms of default strategies in respect of these members, with no input from them.

Defined contribution pension schemes are set up by employers for the purpose of providing benefits in retirement for their employees. Once those members cease to be employees the employer will have no motivation to keep the members' investment options under review, and may not be happy that the trustee board is spending a disproportionate amount of time managing funds in respect of former employees. The use of existing DC schemes for auto enrolment, with the consequent potential increase in deferred members, may provide a catalyst for employers and trustees to look at their rules. Where trust rules oblige members to leave the scheme on ceasing employment it is essential that there is a range of suitable alternative options to which the member can transfer, regardless of the size of the "pot". We therefore welcome the debate that this consultation paper will provide, both in the area of small pension pots and also in respect of the wider issues of providing for deferred members.

Specific Responses

Our responses to your numbered questions are as follows:

Chapter 2

2. We agree with the current barriers as listed and would add that the burden of ensuring the transfer is to properly authorised pension arrangement is on the trustees if they wish to avoid sanctions for unauthorised payments. The increase in pensions liberation plans being advertised on the internet and elsewhere only adds to the due diligence which a transferring scheme needs to carry out and the resultant cost burden.

Chapter 3

3. Encouraging individuals to initiate transfers at the point of leaving employment or on uptake of new employment may be a way of increasing the numbers who transfer, however there are potential difficulties:

i) Existing trustees/employers may be unwilling/reluctant to encourage transfers in case it exposes them to misselling claims should the scheme to which members transfer offer less attractive/more expensive investment options etc.

ii) the timing of such ‘encouragement’ (i.e. when member is starting a new job) may not be optimal for making long term decisions on transfer of pension benefits, for example the member may have a qualifying period of service before being auto enrolled into his new scheme or may be on a probationary period in his new employment.

We do not see any real mileage in attempting to force the industry to adopt standardised transfer forms, instead we think it would be more effective to have a series of licensed arrangements which were essentially ‘preapproved’ with their own standardised documentation which should reduce the costs of transfers, as the transferring scheme would not have to carry out due diligence checks. Any requirement to force existing schemes to accept transfers in is likely to meet with resistance from providers as it has the potential to increase costs for other members.

Whilst there are obvious cost benefits in extending the exemption to the requirement to provide benefit illustrations to deferred members, we see this as counterproductive in the longer terms as it will increase the likelihood of members losing touch with their benefits, and the arrival of the benefit illustration can often be the catalyst that encourages the member to consolidate his pension arrangements by arranging a transfer.

Chapter 4

5. We have a strong preference for the aggregator model over the pension following the individual model for a number of reasons:

i) The number of DC schemes in the UK is unsustainable. If we wish to reduce costs and increase benefits to members it is essential to achieve the necessary scale to enable savings to be made which can only be done with a limited number of aggregator schemes. Use of these schemes will speed up the process of consolidation generally within the DC market.

ii) There is a better chance of successful regulation of a limited number of aggregator schemes. Governance of these arrangements will be easier to monitor and control, therefore this must be the preferred option where compulsion is involved.

iii) The risk of employees being transferred into a scheme with higher charges/ worse investment choices is minimised if the aggregator schemes are all required to meet minimum requirements in terms of fee structures and investment choices.

(iv) Under the aggregate model any one pot is only moved once. Under the alternative model the same pot might be moved many times. This cannot make sense and would be extremely expensive and inefficient.]

7. Consolidation of small DB schemes clearly merits a discussion paper of its own and whilst we see many advantages to aggregating these DB schemes, the processes required to achieve this would be complex, and we have therefore confined our comments to the DC proposals in the paper.

8. We support the principle of automatic transfer of “small pots” with an opt out as it is aligned with the auto enrolment process, and we suspect that many members will not opt out. However, we believe that there are certain cases where automatic transfer may not be appropriate:

i) where the member is close to retirement and the costs of transfer may outweigh the advantages of consolidation on purchase of an annuity.

ii) where the sums involved are not “small” (this being a relative concept in the case of individual members).

Although more cumbersome to administer, we would support a three tier approach broadly as follows:

- i) Automatic transfer for pots below £2,000 (indexed) with no right to opt out. This will take care of a vast number of small pots which the government estimate will be created each year as a result of auto enrolment.
- ii) Automatic transfer with an opt out for pots between £2,000 and £10,000 (indexed) to enable those with some level of accumulation to make a positive decision to stay in a scheme where it may be in their interests to do so.
- iii) Right to transfer but no automatic transfer where pot is over £10,000 or member is within 5 years of state pension age.

9. We support the principle that advice would not be a requirement for an automatic transfer system as any cost savings to the individual in consolidating his pension in a single arrangement would be wiped out by adviser fees, especially if he moves employment 11 times. For cases falling within 8 ii) and 8 iii) above members should be told that it may be in their interests to take independent financial advice, but should not be compelled to do so.

10. We believe there are real practical dangers in trying to fit a retrospective solution to the existing “small pots” issue. This is not something members signed up to when they joined a scheme, and therefore both trustees and employers may be hesitant to

force them out under new rules. These pots where not created under the new auto enrolment provisions and whilst some schemes may have operated auto enrolment for a number of years, for many membership of the scheme will have been a positive

decision by the member and therefore removing them without their consent, even if they can opt out of the transfer, may be unpalatable.

Chapter 5

11. We support the principle of a number of approved aggregator schemes to ensure competition and member choice. The downside to having multiple schemes is that members may end up with several pots at the end of their working life, and may not be happy with the aggregator scheme chosen by their employer. These obstacles could be overcome by giving the member a choice of alternative schemes if he did not wish to transfer to the default scheme, i.e. if he already had one "pot" transferred to a particular aggregator scheme he could elect for future transfers to be made to that scheme rather than to the employer or trustees' choice of aggregator. This would inevitably increase complexity and cost but would leave more control with the members who could compare and contrast the different investment choices and fee structures on offer.

12. We are broadly in agreement with the characteristics outlined, however, we would add ease of disinvestment, i.e. the member must be able to have access to a simple annuity purchasing vehicle at the end of the process.

13. There are already several master trusts established or being established which potentially could meet these requirements, including NEST. These schemes are being set up to take ongoing contributions, and generally have a single percentage rate which covers administration and investment charges, although some have a separate administration charge, not related to asset size. A default aggregator scheme could be a standalone scheme, or could be one open to new contributions in which case it would be important to establish a fair basis of charging so that active members were not subsidising deferred members or vice versa. Given that deferred members are generally less attractive to providers than active members, particularly where they have very small pots, careful consideration will need to be given to charging structures to ensure members pots are not swallowed up by administration and investment fees.

14/15. We have a clear preference for competition in this area and see the new breed of master trusts as potential contenders for the role of aggregator schemes, provided they meet minimum requirements on pricing, investment choices etc. We also see no reason why they should not take new contributions from participating employers. The implications for having several aggregator schemes over the longer term is that some early entrants might not be able to attract sufficient funds or may price their offering too low to in order to attract the market, and subsequently withdraw, leaving the members with the issue of the funds being transferred elsewhere at possible higher cost. However, we still believe this model is preferable to a single supplier, and that even with a number of aggregator schemes licensed to take default transfers there should be sufficient volume to ensure the necessary scale needed to maintain the low cost base essential for the success of these arrangements.

16. As stated above, NEST could also act as an aggregator Scheme alongside other Schemes, although as with other master trusts, it may be necessary to impose separate charging structures for contributing and non-contributing members. It would also be necessary to ensure that NEST had the infrastructure and governance structure in place to cope with the additional volumes, however, these considerations would be the same for any other master trusts which were licensed aggregator schemes for these purposes.

17. We believe we have answered this question in our response to question 8 above. To repeat we favour a three tier approach as follows;

    i) Automatic transfer for pots below £2,000 (indexed) with no right to opt out. This will take care of a vast number of small pots which the government estimate will be created each year as a result of auto enrolment.
    ii) Automatic transfer with an opt out for pots between £2,000 and £10,000 (indexed) to enable those with some level of accumulation to make a positive decision to stay in a scheme where it may be in their interests to do so.
    iii) Right to transfer but no automatic transfer where pot is over £10,000 or member is within 5 years of state pension age.

18. It is arguable that very small pots below a certain threshold should be exempt from automatic transfer and should be returned to the member, effectively allowing short service refunds calculated by reference to the size of fund rather than by the length of service. Inevitably difficulties arise around the date used to calculate the size of pot as this may fluctuate around the cut off point on a daily basis (the same is true for the tiered approach mentioned above). Clearly this would be contrary to the governments stated policy of encouraging workplace savings, and could result in lower paid employees who change jobs frequently failing to amass any savings despite being auto enrolled in a number of different schemes during their working lives. However, if one counters this with the fact they can, in any event, opt out of auto enrolment they would actually be better off if they were allowed to take both employer and employee contributions as cash below a certain level than if they opted out of auto enrolment altogether.

19. We agree that it will always be hard to justify passing transfer costs to members where transfer is by default. Similarly for larger pots where the member opts to transfer we believe it would not meet the objective of encouraging aggregation of pots if the member were forced to pay and would be a disincentive to transfer. We therefore favour splitting the costs between the transferring and aggregator schemes so that each effectively pays its own costs. The transferring scheme benefits by losing the potentially uneconomic small pots, and the aggregator scheme would cover these costs in the overall charges which could be on the same basis for all members.

Chapter 6

20. The proposal that pensions move by default with the individual as he changes job is as yet untried, and although it is being introduced in Australia we have no working examples of a similar system in practice. Whilst this solution may be initially attractive it does not benefit from the proposed regulation around licensed aggregator schemes and relies instead upon schemes and employers voluntarily following the guidance for default funds rather than imposing minimum standards. We do not think this is sufficient where members are being defaulted into an employer's scheme not of their choosing, and which may deliver a worse outcome for the member.

    We are far from convinced that the Australian model is sensible. Costs associated with the same money being marked many times during a pension's career have to be paid for somewhere? The aggregator model is far superior.

21. Any maximum pot size is likely to be arbitrary and will not necessarily reflect the relative proportion of the individual's lifetime savings. For example a pot of say £10,000 may be an insignificant proportion of one person's lifetime savings (both actual and prospective) whereas it is a substantial proportion of another's. If this route were to be selected as the way forward it should be administered in the same manner as the aggregator default, i.e. with an opt out over a certain size.

24. We believe one flaw with this model is that it fails to deal with small pots where the member remains out of employment for a long time or indeed never returns to employed status. There will therefore always be a rump of small pots left behind which are expensive to administer.

25. When dealing with legacy pots we believe that many of the issues identified in respect of aggregator schemes would remain. However, we support the view that members should be encouraged to take action to trace dormant pots and consider transferring them. For reasons stated earlier trustees and employers may be reluctant to encourage transfers where there is potential for misselling claims and therefore suitable protection would be required.

Nita Tinn
Independent Trustee Services Limited
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