Written evidence from the National Employment Savings Trust (APS0040)

About us

Nest was established in 2010 as part of the auto enrolment programme to help people save for retirement. Nest has a legal obligation to accept any employer that wishes to use us to discharge their auto enrolment obligations. Over 890,000 employers have signed up to use Nest.

Over the last decade, Nest has grown to be one of the largest pension schemes in the UK. We are operating at scale as a high quality, low cost pension scheme helping over 10 million members save for their retirement. Many are low to moderate earners who may be saving into a pension for the first time. A typical Nest member earns around £19,300 per year and nearly half our members are aged under 35 years old.

Nest is built around the needs and behaviours of our members, from our approach to responsible investment to our focus on customer service. We occupy a place in the market as a major Master Trust, helping to drive up standards and best practice across the industry. Nest has great potential for delivering pensions to mass market consumers for many years to come, leveraging our scale to deliver value through the combination of low costs, our market leading investment strategy and modernised services all overseen by strong trustee governance.[1]

[1] Employer and member numbers correct as of 14/05/21; Member earnings and age data correct as of 01/06/2020

1. Response

We welcome this opportunity to contribute to the Work and Pensions Select Committee's continued work into the impact of the pension freedoms. We have identified three themes in the Committee's call for evidence: whether members have access to appropriate retirement products; the role of advice and guidance and investment pathways in decumulation decisions; and whether the issues around small pots can be resolved through behavioural changes from savers. We have grouped our responses into three sections according to these themes.

Section 1: Access to appropriate retirement products

The pension freedoms have introduced a new set of set of economic risks for savers. These include longevity risk - the risk of running out of money altogether, or not living as well as they might due to fear of running out of money. Also, ongoing exposure into retirement to investment risks and the need for ongoing management of those investments. Due to cognitive decline as we age, members are also likely to become less able to make decisions about their retirement savings over time.

Nest's research clearly shows that members want and require help to navigate these risks. They have a strong desire for a product which provides some flexibility in the early years of retirement, but in the long-term provides a secure, consistent retirement income that keeps pace with inflation. Due to cognitive and emotional biases as well as information barriers around pensions, they want and require support accessing such a product without necessarily engaging themselves.[2]

This need for support for savers so that they can achieve good outcomes in retirement is consistent with research conducted by the other organisations. Evidence of saver behaviour suggests that people are not currently seeking to balance short and long-term retirement needs, but rather are favouring immediate access to cash in their decumulation decisions. Research by The People's Pension (TPP) found that participants perceived drawdown as a route to accessing tax free cash and that they had given little thought to their remaining pension savings.[3] A report by the Defined Contribution Investment Forum (DCIF) came to similar conclusions.[4] The decisions members are making about accessing their retirement savings are also often not informed by advice or guidance, with The Money and Pensions Service estimating that around half of the people accessing DC pots in 2018-2019 did not receive regulated advice or Pension Wise guidance.[5]

Following extensive research Nest identified six guiding principles to inform the design of governed retirement pathways for DC-dependent savers:[6]

1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions
2. Savers should expect to spend most or all of their pension pots during their retirement
3. Income should be stable and sustainable

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[2] Nest, 'The future of retirement'. Available from: https://www.nestpensions.org.uk/schemeweb/nest/aboutnest/investment-approach/retirement-solutions.html

[3] The People's Pension, 'New Choices, Big Decisions – 5 Years On. Available from: https://thepeoplespension.co.uk/media-centre/policy-research/new-choices-big-decisions-5-years-on/

[4] Defined Contribution Investment Forum, 'Five years of freedom: Evolution, not revolution. Available from: https://dcif.co.uk/wp-content/uploads/2019/11/dcif-2019-evolution-not-revolution-final-1.pdf

[5] T. Shanmugarasa et al, 'Pension Wise Service Evaluation: Experiences and Outcomes of Customers Using Pension Wise in 2018/19'. Available from: https://moneyandpensionsservice.org.uk/wp-content/uploads/2020/01/Pension-Wise-service-evaluation-2018-2019-Experiences-and-outcomes-of-customers-Ipsos-Mori.pdf

[6] Nest, 'The future of retirement: guiding principles'. Available from: https://www.nestpensions.org.uk/schemeweb/dam/nestlibrary/the-future-of-retirement.pdf

4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements
5. Providers should look to offer flexibility and portability wherever possible
6. Inflation risk should be managed but not necessarily hedged

All savers should have access to a suitable retirement product that adheres to these principles, and for that reason we would add a seventh principle: the solution should be low-cost and deliver value for money.

There are different ways to meet these principles. The Nest retirement blueprint includes an income drawdown fund, a cash lump sum fund, as well as a later life protected income fund, to provide the balance between flexibility to meet short-term needs and the desire – and rising expectation – for a consistent retirement income in the long-term.[7] Members would be automatically placed into this fund but they would retain flexibility to take their assets out of their assets out of the scheme if they wished to up until the later years of their retirement.

Nest currently allows members to access their retirement savings through the Nest Guided Retirement Fund[8] (NGRF), which shares many of the design principles of the solution set out in the blueprint, such as an appropriate investment proposition which balances short and long term needs and provides a guided withdrawal rate and a later life income via an annuity. However in the NGRF members' assets remain uncrystallised. Whilst members delay making withdrawals their funds are invested appropriately in anticipation of these future income, emergency cash and/or longer-term needs. The main consequence of members' assets remaining uncrystallised is that they do not get access to the 25% tax free lump sum.

As the PLSA found, whilst there has been some development in the market for retirement products since the pension freedoms, it has been limited, particularly for those with small pots and for solutions which balance short and long-term financial needs of retirees.[9]

Innovation may develop further as pot sizes grow. However, it is likely that for those with small pots, it will continue to be limited due to the market opportunity that these savers represent for providers, as well as a very weak demand side – due to the cognitive and emotional biases and information barriers highlighted above – with very limited shopping around from members. This means there is a clear risk that members with small pots suffer sub-optimal outcomes.

We believe that part of a well-functioning industry should be that all schemes offer or signpost to an appropriate decumulation solution to their members that is straight-through and does not require engagement. For many members this will need to balance flexibility in the short-term whilst in the long-term providing a secure later life income as the NGRF does. We agree with the PLSA that this should be a statutory obligation.[10] The benefit of this, as the PLSA outline, is that it would stimulate the demand side of the market and potentially result in greater levels of innovation.

In the future, as the generation of savers who are entirely reliant on defined contribution savings moves into retirement, attention should turn to how to most efficiently provide a secure long-term income for retirees in the later years of their life. We would like to collaborate with both Government and the industry to explore the provision of a secure later life income. We believe the NGRF is as close to the Nest retirement blueprint as anyone has achieved thus far and is certainly the only one targeted at modest pot sizes. The later life income is constructed from

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[7] Nest, 'The future of retirement: A retirement income blueprint for Nest's members.' Available from: file://ukpensionnest.local/HData$/Home/gturner1/downloads/the-future-of-retirement%20(6).pdf
[8] Nest, 'Nest Guided Retirement Fund'. Available from: https://www.nestpensions.org.uk/schemeweb/nest/retirement/retirement-options/guided-retirement-fund.html
[9] PLSA, 'DC Decumulation: Evolving the pension freedoms – final recommendations'. Available from: https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2020/DC-Decumulation-Final-Recommendations-Oct-2020.pdf
[10] Ibid.

immediate annuities as the only product available today in the UK to achieve this. However, we believe there are more efficient alternatives worthy of consideration.

Nest's retirement blueprint set out two potential options. The first is the purchase of deferred annuities in the earlier years of retirement, and the second a risk sharing arrangement where mortality risk is pooled with other members in a given cohort of members. In the case of the former a deferred annuity or a series of deferred annuities would be purchased from small payments from the income drawdown fund. However, it may not be possible to source value for money policies due to the size of the premiums and the variability of mortality risk in the later years of life. In the latter, members could be pooled into cohorts and their later-life protected income allocations paid into a collective but uninsured mortality pool. Such a structure would be akin to a Collective Defined Contribution scheme (CDC) in decumulation and hence would not be subject to the same risk-based capital requirements as a life company providing an annuity. It may therefore be able to operate with lower costs and offer better value for money for members. However, robust governance frameworks would clearly be required to fairly pay out income from this type of arrangement.

We would welcome further discussion with the Government and industry on the provision of secure later life income.

Section 2: The role of advice and guidance and investment pathways

It is clear that members are not receiving the advice and guidance needed to make informed retirement decisions. The launch of Pension Wise was a positive step, and its interactions have increased by 49% between 2017/18 and 2018/19. However, as outlined above the Money and Pensions Service estimate around half people accessing DC pots in 2018-2019 did not receive either regulated advice or Pension Wise guidance. The FCA's Retirement Outcome Review found that few people shop around, with most tending to take the path of least resistance and entering drawdown products from their pension accumulation provider.

It is possible DWP's 'Stronger Nudge' policy, which will require trustees to refer members to appropriate pensions guidance before proceeding with an application to access pension savings, will increase the uptake of advice and guidance. Similarly the pension dashboard may increase engagement with pensions and lead to higher uptake of advice and guidance. However, even with these interventions, due to the behavioural and information barriers associated with pensions, there is always likely to be a significant proportion of members who are not able or do not wish to engage in decumulation decisions and require significant support from schemes. Furthermore, given that some of the economic risks that savers face in retirement, such as market or investment risks, extend throughout retirement, without solutions like investment pathways savers would have to access advice at numerous points to achieve good outcomes. This would be disproportionately expensive for those with smaller pots given that flat fees that are often charged.

It is worth noting that even the most informed consumers may not be able to make good decisions between products. The FCA found that consumers often face a choice between products with complex features and unclear charging structures and that value for money comparisons are very hard to make effectively. Research also suggests that many in the general population have difficulty interpreting financial information and subsequently taking financial decisions. According to the definitions used in a 2011 Government 'Skills for Life Survey' potentially three quarters of the population may struggle to compare financial products and services for the best buy.[11] This suggests that providing consumers with more information about their retirement choices may not necessarily engender better outcomes for them.

In question 6 of this consultation the Committee asks if there would be benefit in the Money and Pensions service offering enhanced guidance or limited advice to support people making decisions about accessing their pensions in retirement. Whilst there may be some benefit in this, given that people's relationship with pensions in overwhelmingly characterised by disengagement and inertia, it is not likely to effectively guard against poor outcomes for the

[11] https://www.gov.uk/government/publications/2011-skills-for-life-survey

significant numbers of people who do not wish or are not able to make effective decisions about their pension savings. For these people, guided retirement pathways, which automatically place members in a decumulation solution that is appropriate for them and includes sustainable withdrawals with some form of longevity protection, overseen by strong Trustee governance, will be the best way of delivering good retirement outcomes. This type of approach builds in flexibility by allowing for deferred protected income alongside programmed withdrawals, balancing the cost of guarantees and the stability of income in retirement.

In the retail sector, the FCA Investment Pathways, implemented in February 2021, go some way to help address one of the key risks for savers. When savers decide to access their pension through drawdown without taking advice, the pathways nudge savers to allocate their pension saving to one of four investment pathways, according to their objectives. The FCA has also introduced a new duty on IGCs to oversee the value for money of investment pathways solutions for pension drawdown. In the trust sector similar principles, in terms of pathways into appropriate solutions, should be applied to support non-advised savers with modest pot sizes to achieve good retirement outcomes. However importantly in the trust sector, trustees should retain the flexibility to design or signpost to a decumulation solution that is appropriate for members, without the prescription of the four FCA investment pathways. This should be the focus rather than on advice and guidance.

Section 3: small pots

It is possible that interventions like the pensions dashboard will increase engagement in pension saving amongst some groups and lead to greater member-led consolidation of small pots. Developments in fintech may have the same effect, at the margins.

However, the evidence very clearly shows that members' relationship with pensions is characterised by inertia and disengagement. In the Nest scheme over 99% of our members remain in the default investment fund in accumulation, and in decumulation, as the FCA found, members generally follow the path of least resistance into a drawdown product offered by their existing provider. All the evidence suggests that a structural problem like that caused by small pots is highly unlikely to be solved by changes in member behaviour whatever technical solutions are offered.

The focus instead should be on industry and systemic changes to solve the issues around small pots on behalf of members. There are a number of aspects to this. Firstly, we support DWP's decision to ban flat fees on small pots below £100 to protect pots from being eroded to zero.

We also believe that the industry should look closely at the design of administrative systems to mitigate the small pots problem. Members with Nest have a single pot-for-life - they save in a single pot across all of the enrolments they have in the scheme throughout their entire working life. However this is not the industry norm, and many schemes will open a new pot for a member each time they return to the scheme. There are compelling reasons to operate a pot-for-life within any single scheme, not least because savers with several small pots are more likely to cash them in rather than consolidate for the purposes of providing a sustainable income.[12] We would like to see schemes look at their administrative systems to see how they can be reformed.

Further, we are actively engaged with industry partners to consider next steps in relation to small pots. One precondition for systemic solutions to the problem is very likely to be a significant reduction in the cost of transfer between schemes. We are therefore currently working with peers in the industry to look at how the cost of transfers could be substantially reduced in order to facilitate such solutions.

There may also be a case for policy change to address the small pots problem, as outlined in the report from the working group convened by the DWP.[13] Nest is collaborating with the industry and Government consider the potential impacts of options in play.

[12] https://www.gov.uk/government/publications/small-pension-pots-working-group/small-pots-working-group-report#fn:38

[13] https://www.gov.uk/government/publications/small-pension-pots-working-group

Annex

Call for Evidence questions

2. Do people have access to a range of pension options to meet their needs for later life and how might these needs change in future?

3. Are there other pension options, not currently available in the UK, which would better meet people's needs in later life?

4. Are there barriers to providing other pension options which meet a need and are not currently available in the UK?

5. Are people receiving the guidance and advice they need to make informed decisions about how they access their pensions?

6. What role should the Money and Pensions Service have in supporting people accessing their pensions for the first time, including through pension dashboards?

7. Should the Money and Pensions Service offer enhanced guidance or limited advice for people making decisions about their pensions?

8. Can the success of auto-enrolment in helping people save into pensions be replicated for people in retirement through investment pathways?

9. Including costs, what information do consumers need about different retirement products to make an informed choice?

10. Are pension schemes communicating options effectively to members and are there material differences between trust-based and contract-based pension schemes?

11. Can the issues around small pension pots be solved through behavioural changes by savers?

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