5. The role of the National Employment Savings Trust in helping savers to access good quality retirement products

> *'Do you mean that you think you can find out the answer to it?', said the March Hare.*
>
> *'Exactly so', said Alice.*
>
> Lewis Carroll (1865) *Alice's Adventures in Wonderland*

The National Employment Savings Trust (NEST) has revolutionised the DC pension savings market in the UK by providing a high-quality benchmark for private-sector schemes to compare themselves against. We consider whether it can and should do something similar in DC decumulation, both for its own members and for the members of other schemes that do not offer DC decumulation products.

5.1 Introduction

The introduction of NEST has been a game changer for the provision of good-valued, well designed and governed pension schemes for low- and medium-income savers in small and medium-sized companies. It has brought institutional standards – in terms of low charges, good governance and a well-designed default investment fund – to the formerly high-cost, poor-value world of retail customers.[885] It has also encouraged the entry of new multi-employer trust-based schemes, such as NOW: Pensions and The People's Pension.[886] However, under current legislation, once members of these and other auto-enrolment schemes retire, they have to go to the retail market to buy annuities on an individual basis. Even under the new decumulation regime introduced in April 2015, those who do not wish to buy an annuity might end up buying a retail income drawdown product, which at present can be very expensive and suffer from both poor investment strategy and poor governance. Could institutional standards – in terms of design, governance and charges – be brought to the retirement income space and what role could NEST play in achieving this?

Two key topics are covered in this Chapter. The first deals with NEST's approach to developing a retirement income strategy for its own members. The second explores the potential for NEST to play a role in the wider market in relation to employers that want to

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[885] In July 2014, the government announced that in 2017, it would remove the contribution cap and lift the transfer ban imposed on NEST.

[886] Debbie Harrison, David Blake and Kevin Dowd (2012), *Caveat Venditor: The Brave New World of Auto-Enrolment Should be Governed by the Principle of Seller Not Buyer Beware*, Pensions Institute, October (www.pensions-institute.org/reports/caveatvenditor.pdf); and Debbie Harrison, David Blake and Kevin Dowd (2014), *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute, January (www.pensions-institute.org/reports/ValueForMoney.pdf).

offer a third-party retirement income solution to their scheme members, and also to the millions of private sector workers who are self-employed or whose contracts of employment do not entitle them to membership of their employer's auto-enrolment scheme. We begin with a brief summary of NEST and its current membership.

5.2 NEST and its membership

By 2018, all private-sector employers must establish a qualifying workplace auto-enrolment scheme in order to fulfil their legal duties. This essentially means that any worker between 22 and state pension age with earnings above the Earnings Threshold of £10,000 (in 2015-16) must be auto-enrolled into a DC workplace pension scheme. NEST is one of the largest schemes with over 2m members from 14,000 employers.[887] These numbers will increase significantly between now and 2018, as NEST will be the scheme of choice for many smaller companies that reach their staging date over the next two years.

NEST is a non-departmental public body (NDPB) and is run as a trust by NEST Corporation, which is the trustee. The scheme was introduced by the Government to avoid the danger of market failure under auto-enrolment, whereby employers considered economically unattractive to traditional life officers might not be able to find a suitable provider.

While NEST resembles other large master trusts, it is unusual in several respects:

- It is a new scheme, designed specifically for the auto-enrolment market. It opened for business in October 2012 to coincide with the first auto-enrolment staging date for large employers[888]
- Its legal structure is similar to any other multi-trust scheme, but as a NDPB, NEST Corporation is accountable to Parliament through the Department for Work and Pensions
- Members of the Corporation (the chair and up to 14 trustees) are appointed by the Secretary of State for Work and Pensions in line with public appointments guidance
- NEST does not have shareholders (unusual, but not in itself unique) or a parent company that provides new business capital. Instead its establishment and administration costs are funded by a Government (DWP) loan facility. The initial loan was £171m and this had increased to £387m by 2015. Details about the terms and

[887] NEST Annual Report 2015;
http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/news/NEST-reaches-2-million-members.html.
[888] NOW: Pensions is also new and shares this characteristic, although this scheme is funded by NOW's Danish parent company, ATP, which is one of the largest pension schemes in Europe.

conditions of the loan are available in a Freedom of Information (FOI) report, although certain sections have been redacted[889]

- In order to repay the loan, NEST has a dual charging structure, whereas most modern schemes have a single annual management charge (AMC) or total expense ratio (TER). NEST has an AMC of 0.3% and a contribution charge of 1.8% - the latter being used to repay the loan. The two charges combined are broadly equivalent to a TER of 0.5% for members who stay sufficiently long in the scheme
- NEST is the only multi-employer scheme with a public service obligation to accept any employer that applies
- Although NEST will accept any employer, many of its employer members are either smaller companies or companies with lower-paid staff and/or high staff turnover
- NEST accepts the self-employed as individual members – by 2015, about 800 have joined
- NEST cannot accept transfers-in until April 2017
- There is an annual contribution cap – again until April 2017. This is the maximum amount that can be contributed to any member's retirement pot in a tax year. The contribution limit for the 2015-16 tax year is £4,700. It is adjusted annually in line with average earnings.

In October 2015, NEST became the fourth occupational DC master trust to obtain Master Trust Assurance Framework (MAF) status. This is a voluntary framework, developed by the Institute of Chartered Accountants of England and Wales (ICAEW) in association with The Pensions Regulator (TPR), to support auditors to provide independent assurance reports for the trustees of master trusts. The other schemes with MAF status at the time were NOW: Pensions, SEI Master Trust and The People's Pension. There are currently around 70 master trusts operating in the UK.[890]

5.3 NEST's approach to developing a retirement income strategy for its own members

Many life companies have struggled to meet the April 2015 deadline for introducing 'freedom and choice' and making available a suitable choice architecture and product range for decumulation. NEST is more fortunate and is well-placed to deal with the new pensions tax regime. Until the 2014 Budget announcement, the scheme had assumed that its members would either take their fund as cash, where it was small enough to qualify under

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[889] One section redacted relates to the applicable interest rate. This is because 'the description contained within it could prejudice Government policy in future lending to other public sector bodies and the methodology used by the Debt Management Office in setting interest rates for such loans'. The second redaction has been made 'because we have concluded the information would otherwise prejudice NEST Corporation's commercial interests and has commercial importance to other pension providers'.
See https://www.gov.uk/government/publications/national-employment-savings-trust-nest-loan-agreement.
[890] Reported in Jonathan Stapleton (2015) NEST obtains master trust assurance, Professional Pensions, 15 October.

the trivial commutation rules, or in the form of tax-free cash and an annuity. As it was evident that pot sizes would be small – particularly in the early years – the scheme established a panel of annuity providers that were prepared to offer annuities for pot sizes as low as £1,500.

Following the introduction of 'freedom and choice', NEST has adopted a new short-term strategy. Members coming up to retirement over the next few years will have very small pots – and until 2017 they will not be able to use NEST to consolidate this pot with their other private pensions because NEST is unable to accept transfers-in before this date. Therefore, NEST expects most members retiring over the next few years to take their entire pot as cash and, for this reason, these members will be in a target date fund[891] that will be fully invested in cash at the point of retirement.

Furthermore, NEST does not have to deal with legacy books of workplace DC business. Given the recent focus of the FCA's Independent Project Board on treating legacy customers fairly, back books – where policies often have charges that are very high relative to modern schemes – are likely to cause problems for the new independent governance committees of contract-based workplace schemes.[892]

5.3.1 NEST's consultation on the future of retirement and the guiding principles for designing retirement income defaults

NEST has set out its longer-term plans for scheme decumulation in several reports, starting, in November 2014, with a consultation paper, *The Future of Retirement: A Consultation on Investing for NEST's Members in a New Regulatory Landscape*.[893] In March 2015, it published an interim report, *The Future of Retirement: Guiding Principles for the Design of Retirement Pathways for the Automatically Enrolled Generation*, that set out 'six principles for meeting the needs of new generation of savers'.[894] Launching the report, Mark Fawcett, NEST's chief investment officer, said:

> *The new 'freedom and choice' reforms provide a great opportunity to deliver innovative solutions for millions of savers who will be increasingly reliant on DC pots. What we are seeing is a strong consensus emerging on*

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[891] See Chapter 2.

[892] FCA (2014) *The Independent Project Board Report: Defined Contribution Workplace Pensions: The Audit of Charges and Benefits in Legacy Schemes - A Report from the Independent Project Board*, December; http://www.fca.org.uk/your-fca/documents/defined-contribution-workplace-pensions.

[893] NEST (2014) *The Future of Retirement: A Consultation on Investing for NEST's Members in a New Regulatory Landscape*, November; https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement.pdf.

[894] NEST (2015) *The Future of Retirement: Guiding Principles for the Design of Retirement Pathways for the Automatically Enrolled Generation*, March; http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/guiding-principles.pdf.

> *good quality default retirement income solutions playing a central role in helping these savers achieve better retirement outcomes.*
>
> *Much of the evidence we are analysing indicates broad agreement that helping savers mitigate the risk of outliving their savings will be a key feature for default solutions right for the DC-dependent generation.*

An important insight that emerged from the consultation is that DC savers are just as likely to underdraw as they are to overdraw their DC savings. International experience backs up this finding. The experience in the US is that DC retirees underspend, while in Australia they overspend with the result that many retirees run down their DC savings by the age of 70 (see Chapter 3).

The key findings of the consultation include the following:

- There is a need for default retirement income solutions
- The design needs to be flexible
- There is a need to manage the risk that people will run out of money because they live longer than expected (i.e., longevity risk)
- No amount of education can prevent people from making complex decisions they later come to regret
- Choice is a double-edged sword. Most DC savers like to have choice in principle, but if the choices are complicated, then they get anxious and confused, often resulting in sub-optimal decisions
- People cannot and should not be expected to know when they will retire. This is partly because there are simply too many lifestyle, health and financial 'unknowns' in the decade before retirement. It is also due to the increasing trend towards flexible retirement, i.e., working past 'normal retirement age', often on a part-time basis.

NEST notes that the language of 'defaults' is somewhat flawed in relation to decumulation options because there must be more than one choice – i.e. cash, annuity, drawdown, and a combination of all three. Despite this, NEST chooses to use the term 'default' to denote the income drawdown default fund and investment strategy. As retirees come to rely increasingly on DC as a primary source of private retirement income, NEST believes that drawdown will represent the most sensible option, provided, as it also emphasises, the decumulation strategy also includes a longevity risk hedge in the form of a later-life annuity.

NEST's consultation respondents were broadly in agreement about the key features of the drawdown scheme. It needs to demonstrate:

- Simplicity from the member perspective
- Value for money through economies of scale and expert governance
- Freedom to opt out, which is essential under the 'freedom and choice' regime, and

- A clear choice architecture.

Respondents also suggested that instead of complex annual statements based on investment performance and fund size, the statement should focus on meeting income targets.[895] It is much more meaningful for retirees to understand their retirement pot as a series of income payments, so the statement should adopt a similar language to that used in annuity income statements, but with the important caveat that the drawdown income is not guaranteed.

NEST's six principles for designing retirement income defaults for auto-enrolment savers are as follows:

1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions.

   Many people underestimate how long they will live and therefore what they are likely to need to secure an appropriate income in retirement.

   The latest projections for England suggest males born in 2014 could expect to live to 79.5 and females to 83.2.

   Under the previous pensions framework, annuities met savers' need to manage long-life risk. However the new freedoms mean schemes may have a part to play in helping to manage this type of risk.

   In comparison with buying an annuity, many question how appropriate attempting to manage longevity risk by primarily investing in growth-seeking assets is.

   Buying an annuity at a later age can allow individuals to draw a higher income than would be considered sustainable if they were trying to achieve this through a drawdown portfolio.

2. Savers should expect to spend most or all of their pension pots during their retirement.

   DC-dependent savers' pots are likely to be their main source of retirement income, alongside the state pension.

   Using all or most of savers' pots to produce an income should be the main objective of suitable default solutions.

[895] This had previously been recommended in Debbie Harrison, David Blake and Kevin Dowd (2014) *VfM: Assessing Value for Money in Defined Contribution Default Funds*, Pensions Institute.

Other considerations, such as being able to leave money to dependants, should not be a key driver when designing appropriate retirement options for DC-dependent savers retiring in the medium term.

Strategies for managing these savers' money when they retire will be different from traditional drawdown strategies aimed at those with larger pots. These may be managed in ways that allow individuals to both leave what may be left of their savings for others, as well as maintain an income through retirement.

3. Income should be stable and sustainable.

   Those who are dependent on their DC pot for retirement income ought to have access to arrangements that protect them from dramatic rises and falls in that income.

   Their needs will also be met by strategies designed to mitigate the risk of them running out of money, while still aiming to produce a stable income.

4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements.

   For savers who are reliant on income from their DC pots to meet the cost of living, taking advantage of potential investment growth opportunities is appealing. However, minimising the chance of running out of money is likely to be of greater importance for the majority.

   Investment risk will need to be managed to reflect this. Investment strategies should also reflect that, unlike when savers are building up their pots, where there are losses, there is less time to make up those falls.

   Importantly, the impact of falls is exacerbated by the likelihood the individual will be taking money out of their pot. This is particularly an issue when pot sizes are at their largest.

5. Providers should look to offer flexibility and portability wherever possible.

   Savers value choice and are likely to appreciate the freedom to move between different vehicles at and during retirement. Arrangements for DC savers ought to reflect this.

   However, some factors are likely to constrain elements of flexibility and portability. For example, it may be that some savers can access a higher or more stable income if they decide to have a proportion of their pots in illiquid assets or a mortality pool which would not allow them to cash out without it costing some of their pot by moving.

It is these sorts of considerations retirement arrangements will have to assess in designing solutions that meet the expectations of savers while aiming to provide a stable income.

Schemes may also need to reflect that flexibility may be more important during the transitional years from building up your pot to accessing it, than it is in later years.

We suggest there will be many cases where savers will see the best outcomes when they have enough flexibility to respond to changing circumstances. However, they are less likely to get a good outcome if they move too frequently. Moving too frequently means savers' pots will incur transactional costs and lose out on other advantages of staying in the same strategy such as benefiting from mortality cross-subsidies.

6. Inflation risk should be managed but not necessarily hedged.

   Many savers are likely to be in retirement for decades. Over this time, the cost of living is assumed to rise.

   As inflation can have a dramatic impact on income in retirement, this means investment strategies ought to be designed to produce a stable income in real terms.

   This will, in turn, mean balancing the need to keep pace with inflation and provide income without taking undue investment risk.

NEST announced that it would be working on a blueprint for designing retirement income defaults based on these principles. It also recognised that these principles might be in tension with each other and that providers need to prioritise and understand the trade-offs in designing default options. However, Mark Fawcett gave an early indication of NEST's preferences. He accepted that 'for many members, flexibility in the early stages of retirement is key, as they will simply not know what their income needs will be….[But], as retirees get older they need less flexibility and longevity risk becomes the most important risk'. The preferred solution is likely to be a hybrid product that is a blend of drawdown in the early years and longevity insurance in the later years, but with the ability to opt out of this. This would mean fund managers would need to partner with insurance companies to provide deferred annuities that begin at age 80 or 85. Furthermore, costs should be as low as possible in order to give good value to savers: 'One advantage of [the preferred] solution is the drawdown phase is at a similar cost to accumulation but with some additional risk management techniques. One of the challenges in keeping costs low is to encourage insurance companies to compete on price, [for example, using] a panel of providers'.[896]

[896] Reported in Amanda White (2015) Best practice de-cumulatisation - a hybrid approach, Top1000funds, 14 May.

5.3.2 NEST's proposals for implementing the guiding principles for designing retirement income defaults

NEST's final report, *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, was released in June 2015.[897]

The report begins by revealing what members want from their retirement incomes. This is broadly the same as we found in Chapter 2, namely that:

- a substantial proportion of people want to use their pension pots to generate an income in retirement
- there is significant demand for using retirement arrangements to provide an inflation-protected income. This would be without significant market risk and guaranteed to last for life.
- people are not only interested in a stable income for life, they also express strong preferences for having access to lump sums and the ability to pass on their savings, particularly in the event of early death.

It then identifies three phases of retirement during which people are likely to accept 'differing proportions of flexibility, inflation protection and longevity protection':

- Phase 1, typically mid-to-late 60s to mid 70s, where the priorities are to maximise sustainable income in real terms and to preserve flexibility for later periods
- Phase 2, mid 70s to mid 80s, where the aim is to provide a steady income that aims to keep pace with inflation, whilst keeping the majority of the pot liquid, so that it can be passed on to dependants on death
- Phase 3, mid 80s onwards, where the aim is to protect the member from all or most investment risk and longevity risk, at the cost of a loss of flexibility.

The issues arising in each phase and the potential solutions are considered in Table 5.1.

The main part of the report covers the blueprint for a core retirement income strategy. This has a number of aims:

- to provide a regular sustainable income for retirement
- to provide members with the ability to access lump sums without disturbing their regular income stream
- be low cost and feel straightforward for the member.

[897] NEST (2015) *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, June; https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement,pdf.pdf

Table 5.1: Meeting the different objectives of a blueprint for a core retirement strategy

Phase	Capital market returns vs. mortality credits	Lifestyle and behavioural influences	Potential solution
One	Expected returns from investments much higher than benefits of mortality pooling.	Members entering retirement have little sense of what their consumption needs will be. They are likely to have ad hoc needs until they settle into retirement and aren't focussed on long-term needs.	Remain fully invested in an income drawdown strategy. Use cash lump sum fund for ad hoc needs without impacting their regular income.
Two	Mortality credits become increasingly more valuable overtaking expected investment returns.	Members are more settled into their retirement, have a better sense of their likely future spending needs and are becoming less active. More recognition that they are likely to need a retirement income for longer than previously expected.	Secure a later-life income with a portion of their remaining pot. Remain invested in the income drawdown fund to provide sustainable income in real terms. Use cash lump sum fund for ad hoc needs without impacting their regular income.
Three	Variance of both longevity and value of remaining pots is too high to manage or plan for by using capital markets.	Many members at this age will be less active and less engaged with their finances, preferring instead for certainty in their regular income.	Draw from later-life protected income building block. Use cash lump sum fund for ad hoc needs without impacting their regular income No longer use investment supported income drawdown fund.

Source: NEST (2015, p. 31) *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, June.

Table 5.2: Meeting the guiding principles	
Guiding principle	How the blueprint for the core retirement income strategy meets the principle
1. Living longer than expected and running out of money is the key risk in retirement and a critical input into retirement income solutions.	This blueprint aims to manage longevity risk through the later-life protected income fund.
2. Savers should expect to spend most or all of their pension pots during their retirement.	Phases 1 and 2 of the blueprint would aim to pay out sustainable income. Any excess returns should be paid into the cash lump sum fund. Later-life protected income provides security in Phase 3 so no money needs to be 'left on the table'.
3. Income should be stable and sustainable.	By having a clear investment horizon (the end of Phase 2), the drawdown investment strategy can be managed with clear objectives. The investment strategy should be balanced and diversified.
4. Managing investment risk is crucial as volatility can be especially harmful in income drawdown-type arrangements.	There should be a clear requirement in the income drawdown fund to manage for volatility and sequencing risk.
5. Providers should look to offer flexibility and portability wherever possible.	A core design principle for this blueprint is that it doesn't lock members in early in their retirement and gives them flexibility with their money when it's most needed. Full flexibility is a key feature of Phase 1. This is the most important time for flexibility as work and retirement patterns change and income requirements are uncertain. By Phase 3, there will generally be less need for this level of flexibility. It becomes more important to provide reassurance that the money will last as long as it needs to.
6. Inflation risk should be managed but not necessarily hedged.	Inflation hedging is expensive but a well-managed drawdown fund could provide reasonable inflation protection in Phases 1 and 2. Inflation protection is arguably less important in Phase 3.
Source: NEST (2015, p. 6) *The Future of Retirement: A Retirement Income Blueprint for NEST's Members*, June.	

To achieve these aims, the blueprint discusses three building blocks which cover the three phases of retirement:

1. An income drawdown fund – To provide a steady income that aims to protect members against inflation, as well as give them full flexibility to change their mind and withdraw some or all of their money.
2. A cash lump sum fund – To be highly liquid so it can be used by members for unexpected events without impacting their core income stream. If market conditions are good then this pot can be topped up with additional lump sums. This would be a fund from which members could move money in ad hoc lump sums into their bank account to use as they like.
3. Later life protected income – To be 'bought' gradually over time through small payments from the drawdown fund. This would remain refundable up to a certain age, at which point that money is locked in to ensure a secure income is available for the remainder of a member's life to protect against the risk of running out of money before they die.

Table 5.2 shows how the blueprint meets the guiding principles. NEST believes that the guiding principles are of particular importance given that its research had shown that a 'significant proportion of members may be unwilling or unable to pay for financial advice'.

The retirement income and investment strategies post-retirement operate as follows:

1. 10% of the pension pot at retirement will be kept in a cash lump sum fund (which will invest in liquid money market instruments) in case the member wants to make ad hoc withdrawals for a holiday, say.
2. The drawdown phase is designed to pay an inflation-linked income of 4% for 20 years from 65 to 85. With 10% of the pension pot in liquid assets, the remaining 90% of the pot has to produce a return of at least 4.4% to give an overall target return of 4%.
3. During drawdown between 1.5% and 2% of the pot is drip-fed into the protected income (annuity) fund each year. This is a collective fund, not an individual fund.[898]
4. The drawdown strategy is designed to have a 'high probability' of generating a sustainable income until age 85. NEST plans to find out from its members what probability levels would be 'acceptable'. The report shows that a 'high portfolio risk' portfolio (which is dominated by equities) has a 5% probability of running out of money in 20 years, while a 'low portfolio risk' portfolio (which is dominated by liquid assets) has nearly a 25% probability of running out of money over the same period. By contrast, the 'median portfolio risk' portfolio (which is a highly diversified fund)

[898] This is similar to the 'collective individual DC scheme' discussed in the next Chapter. It also has similarities with the one of the 'defined ambition' options considered by Steve Webb when he was Pensions Minister, namely, the 'pension income builder' fund, although that involved making contributions *prior* to retirement.

has just a 2% probability of running out of money in 20 years. Any money remaining in the income drawdown fund at age 85 would be moved into the cash lump sum fund.

The later-life protected income would be provided ideally using deferred annuities, although that is subject to the willingness of the insurance industry to provide these products at a reasonable cost.NEST is aware of the challenges in delivering the blueprint for a core retirement income strategy. It accepts that the two key risks that will need to be managed in Phases 1 and 2 are sequence-of-returns risk[899] and inflation risk. It also recognises that in Phase 3, advanced life deferred annuities might not be available, in which case other internal solutions, involving elements of risk sharing, might have to be considered. Cost, as well as hedge effectiveness, will also be an important consideration.

Mark Fawcett said: 'Since the pension freedoms were announced the challenge to industry has been to help savers achieve a sustainable retirement income without removing freedom and flexibility. We believe this is possible but it requires innovation. Many of NEST's members are the first generation of savers who'll rely almost entirely on their DC pots and their state pension in retirement. This makes it absolutely critical that we get this right for them. We've developed an evidence-based blueprint for how to meet members' needs. We hope this will stimulate the innovation necessary for us and others to deliver what members will need and want'.

5.4 A wider role for NEST in the DC decumulation market?

Is it possible that NEST could have a wider role in the DC decumulation market? There are EU rules on competition and state aid in relation to Government intervention in markets. In 2010, the Government had to present a convincing case that NEST was necessary to ensure the successful implementation of automatic enrolment, i.e., without it there could be a market failure. The Government also argued that it was fair and reasonable to support the scheme through the provision of a Government loan.[900] The loan was justified on the grounds of the cost implications of NEST's public service obligation:

> *NEST will have a public service duty, to accept all employers who want to use the scheme to discharge their duty to automatically enrol workers, irrespective of costs. This means NEST will be required to bear costs other pension providers do not face. In recognition of this, and in order to preserve the scheme's low-cost aims, the Government intend to provide relief to the scheme to limit the overall interest charges scheme members incur on funds borrowed to the Government's cost of borrowing. The Government are currently seeking the European Commission's approval*

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[899] This is examined in Chapter 2.

[900] House of Commons Library (2010) *National Employment Savings Trust (NEST) – Background.* Standard Note: SN 04826, November; http://researchbriefings.files.parliament.uk/documents/SN04826/SN04826.pdf

> *that this approach is consistent with European rules on competition and state aid. The Government believe that this funding package represents a fair balance between delivering good value to NEST's members, ensuring affordability for the taxpayer and putting NEST on a level playing field with the existing pensions industry.*

As far as EU competition law is concerned, NEST can enter the DC decumulation market if it wishes. If it needs a subsidy to do so, that is when it could require a state aid clearance. If it requires a state subsidy, there is no requirement to show that a market failure has already occurred, only that the Government has a reasonable belief, on the balance of probabilities, that a market failure is likely to occur given the information currently available. It is also open to the Government to define what it considers market failure to be. For example, the Government could argue that a market failure is likely to occur if (a) a significant number of DC savers are mis-sold inappropriate retail drawdown products that are likely to run out of money early due to a combination of high charges and inappropriate investment strategies, or (b) solutions with institutional standards – in terms of low charges, good governance and a well-designed decumulation default offering drawdown with longevity insurance – do not soon become available to the mass market.

NEST – or an independently constituted sister organisation set up along the same lines – has the potential to provide a national decumulation scheme similar to its accumulation offering, since:

- It offers a low-cost, low-risk approach that is designed for the mass market, including lower earners
- It demonstrates high standards of governance through its independent trustee board
- It is open to the self-employed and employees whose contracts of employment make them ineligible for auto-enrolment.

The self-employed and non-eligible job holders for auto-enrolment could be allowed to participate in such a scheme.

Finally, in terms of the legal framework necessary for NEST to become a national decumulation aggregator, we were informed that: 'In order for NEST to become a general aggregator to the nation, it would have to become a Regulatory Own Fund (like the Pension Protection Fund). We think this could happen. It may well be that NEST remains a master trust to accumulate but has a separate structure – a Regulatory Own Fund structure – for decumulation. This would happen not just because of demands from consumers (fuelled by the pension freedoms) but because this is about the only way that a collective approach to spending (including longevity pooling) is going to work'.

5.5 Reactions to the NEST proposals

There was support for the idea of the Government setting up a national drawdown provider with lower charges, similar to NEST, even before the NEST blueprint was published.

For example, in February 2015, the Trades Union Congress came out in support of the idea of a good default in decumulation and called for the establishment of a low-cost master trust for drawdown, similar to NEST, which would help to establish good practice, good standards and good value to which other products can then be compared. Nigel Stanley, then head of campaigns and communications, said: 'The history of financial services tells us that financial markets don't provide good protection for consumers. The whole pattern is innovation, rip-off, concern, regulation, and eventually you get more on this product. There's a danger that we'll go through that for the new decumulation products as well. … NEST's role in the accumulation stage has been absolutely central. My idea is that we bring exactly the same insight and lessons into the decumulation process. I think the default provider needs to have a public service obligation to accept funds, particularly occupational pensions, run by employers who do not want to look after the decumulation phase. Furthermore, I think it should play exactly the same role in setting standards and it should be based around a model where there is innovation and people have every right to opt out, but still have that choice'. [901]

Similarly, in March 2015, Which?, in a report called *Better Pensions*,[902] said: 'In the same way as it created NEST to enable all consumers to save into a pension, the Government should lay foundations for a low-cost, high value government-backed scheme for consumers to take money out of their pension. Once appointed, that provider should develop product defaults that match consumers' needs (e.g., by managing risk and volatility, offering low charges, and providing some flexibility so that members can adjust to changes in personal circumstances)'.

The report recommends that any 'disengaged' customer should be defaulted into this provider. It also recommends that any default drawdown product sold by any provider (i.e., where the customer does not make an active choice) should have a charge cap in the same way that default funds used in the accumulation stage of auto-enrolment schemes have a charge cap (of 0.75%).

The report goes on to recommend that the Financial Services Compensation Scheme's cover to be increased in the case of drawdown: 'In the event of a product provider going out of business, some funds invested via SIPPs are subject to protection under the FSCS, but only

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[901] Reported in Stephanie Baxter (2015) TUC warns DC flexibilities will allow 'perfectly legal' rip offs, Professional Pensions, 16 February; and Adam Cadle (2015) Soapbox – The decumulation dilemma, Pensions Age, February.

[902] http://www.staticwhich.co.uk/documents/pdf/better-pensions-report---march-2015-397468.pdf

to a maximum compensation level of £50,000. This level of protection would prove inadequate for many consumers' retirement savings. Annuities, on the other hand, because they are classed as insurance products, are subject to more generous protection'.[903]

Similarly, in a report entitled *Some Suggestions for the New Pensions Minister*,[904] published by the Centre for Policy Studies in May 2015, author Michael Johnson recommends Baroness Altmann to do the following:

- Encourage NEST (and its competitors) to develop a collective drawdown capability to enable retirees to pool their longevity risk
- Establish a not-for-profit national annuities auction house to automate the process of shopping around, adding to pricing tension and transparency.

There were three main industry reactions to the NEST blueprint when it was published:[905]

- The 'complexity' of the proposed solution, which appears more appropriate for engaged investors with large pension pots than to typical NEST members who are not interested in pensions and in any case have a small pension pot.
- Whether the FCA would agree to disengaged investors being defaulted onto a risk-based retirement income solution.
- The potential cost of developing the blueprint to practical implementation and whether this a good use of public funds.

Tom McPhail, head of pensions research at Hargreaves Lansdown, said:[906]

> *NEST's research echoes market experience of the first weeks of the pension freedoms, with investors overwhelmingly favouring drawdown ahead of annuitisation, for now at least. They have some good ideas here, however, their proposals do set a couple of interesting challenges. Insurance companies have shown precious little appetite for developing a deferred annuity market though perhaps NEST's blueprint will now stimulate more interest. They will also bump up against the challenge of communicating drawdown risks to their customers, some of whom are likely to be*

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[903] The report made a number of other recommendations, including:

- a cooling off period for at-retirement product purchases
- increase enforcement activity against scams and the distribution of unregulated collective investment schemes
- allow pension providers to book an appointment with guidance service Pension Wise on customers' behalf.

[904] http://www.cps.org.uk/files/reports/original/150514105646-SomeSuggestionsfortheNewPensionsMinister.pdf

[905] Reported in Michael Klimes (2015) NEST reveals plan for in-scheme drawdown and deferred annuities, Professional Pensions, 27 June.

[906] Quoted in Jenna Towler (2015) NEST launches retirement income strategy 'blueprint', Professional Adviser, 27 June.

relatively disengaged. The Financial Conduct Authority is unlikely to look kindly on a solution which involves putting disengaged investors into a risk-based retirement income solution. We also know that to date, investors have shown no appetite for buying deferred annuities, so packaging this up in a way which is attractive to investors could be challenging and complicated.

While they have not yet been able to put a price on the deferred annuities, NEST project that this package of measures could deliver an income of 4% a year. This income would be inflation linked up to age 85. For comparison, a level annuity would typically pay about 6% at current rates and a drawdown plan purely distributing the income from the underlying investments would pay about 3.5%.

NEST has the luxury of not needing to rush into a retirement income solution for the pension freedom world. Its members typically have only a few hundred pounds in their accounts at present and very few of them are currently making retirement income withdrawals. This could change after 2017 when NEST will be able to accept transfers in from other schemes.

Mr McPhail's views on the NEST blueprint appear to have mellowed slightly since he made the following comments on the Which? report *Better Pensions* in March 2015: 'Disengaged investors should probably either buy an annuity or take financial advice (or possibly both). Defaulting them into drawdown plans when they don't understand the risks look like a recipe for disaster'.[907]

Immediately following the release of the NEST blueprint, Emma Douglas, head of DC solutions at Legal & General Investment Management, speaking at Pensions & Benefits UK 2015, said that income drawdown may need to be delivered collectively to account for demand from the mass market: 'There is a lot to be said for [a collective solution] in that we are looking at a mass income drawdown market where many cannot afford an adviser. They will want something that is off the shelf, low cost and easy to understand. However, they will need some element of guidance so maybe that could be delivered via a collective solution'. [908]

5.6 Feedback from our interviews and responses to the consultation paper

5.6.1 Feedback from our interviews

A number of the consultants we interviewed supported the idea of a NEST-style national decumulation scheme. One said: 'Yes. This would appeal to a lot of employers because there

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[907] Reported in William Robins (2015) Which? calls for Nest-style national drawdown scheme, Citywire, 6 March.

[908] Reported in Helen Morrissey (2015) PBUK 2015 - Collective solutions could deliver mass market income drawdown, Professional Pensions, 30 June.

is an assumption of safe harbour. Advisers – retail as well as corporate – would like this too, because it would give them a home for customers who are not economic to serve separately. This could be better than BT's SIPP solution. I am concerned that the SIPP charges are still too high, even though BT has tried to negotiate them down'.

There was also support from the trade union representatives we talked to, although some were concerned about whether NEST itself should operate the decumulation scheme:

- 'NEST should provide decumulation'
- 'But the worry is that NEST is new. It is very early days. I would not like to see all that good work wither away'
- 'Perhaps we do need a new organisation that operates on the same lines as NEST with a similar public service obligation'.

Providers and investment managers tended to have more doubts:

- 'NEST was introduced because of market failure in auto-enrolment. But is there evidence of market failure in DC decumulation? If not, you are bringing in to the market a government/taxpayer-subsidised loss-making provider as a solution'
- 'Potential for "mission creep" – NEST did not initially offer scheme drawdown for its own members, but it can take transfers in after 2017 and could start to offer drawdown services to this group'
- 'Given that advice is essential, could NEST provide this?'
- 'There is a huge government liability if NEST gets decumulation wrong. If decumulation goes wrong, it goes wrong quickly'.

5.6.2 Responses to the consultation paper

We summarise the responses to Questions 41-46 in the consultation paper here.

41. *Should NEST provide retirement income products to its members?*

Half of the respondents (a majority of those that had a clear view on the matter) thought that NEST should provide retirement income products, citing NEST's ability to use its economies of scale, the links between accumulation and decumulation, and pensioner inertia in seeking out good products. However, a significant minority – 35 per cent – were against the idea, mainly on the grounds that there was not yet any evidence of market failure in the provision of retirement income products and that this would also involve NEST operating beyond its original remit.

42. *(a) Should NEST provide a default decumulation product (e.g., scheme drawdown or annuitisation)? (b) If so, what quality standards should apply (e.g., in terms of charge caps, governance)?*

Of the respondents who were happy for NEST to provide retirement income products, 43 per cent agreed that there should be a default or a menu of default opinions, 28 per cent were against, and the rest were unclear. Most thought existing quality standards would be appropriate.

43. *Are there any other ways in which NEST can help savers to access good quality retirement products?*

Most respondents suggested that NEST could provide guidance, advice or something in between, and also signpost customers to appropriate products. One respondent suggested the importance of engaging with pension savers on an on-going basis. There was also a suggestion that NEST might provide an annuity shopping service.

44. *In an aggregator model for stranded pots: (a) Would it be desirable for NEST to act as one of the aggregators? (b) Which other schemes could act as aggregators?*

The vast majority – 73 per cent – of respondents thought that NEST could be an aggregator for stranded pots, but this did not imply that NEST should take on this role. A minority of respondents thought that it was inappropriate for NEST to be an aggregator. All respondents agreed that NEST should not be the only aggregator, but there were relatively few responses to the second part of the question.

45. *Could NEST do more in decumulation for the self-employed and workers excluded from auto-enrolment?*

The overwhelming majority of responses expressed no strong view on whether NEST could or should do more in decumulation for the self-employed and workers excluded from auto-enrolment.

46. *(a) Could NEST become a collective pension scheme? Explain. (b) Should NEST become a collective pension scheme? Explain.*

Respondents were equally divided on whether or not NEST should become a collective pension scheme, with strong views on both sides.

5.7 Analysis and recommendation

There were mixed views on whether NEST should offer decumulation services. There was support from the unions and some consultants. Providers on the other hand tended to emphasise issues like 'mission creep' and distortion to the market by a 'Government/taxpayer-subsidised loss-making provider'.

Even if the Government went ahead with the proposal, it would face at least two additional hurdles, according to a pension lawyer we interviewed. The first relates to EU rules on state aid which prohibit the state from supporting businesses that undercut other private-sector providers – this could be overcome with a letter of comfort from the EU as was used when NEST was set up. The second concerns giving NEST's decumulation product an implicit safe harbour status. This would undermine the FCA's current rules on regulated advice by giving an exemption to a Government-backed provider that was not available to advisers.

Notwithstanding these issues, NEST's blueprint for designing a retirement income strategy comes very close to how a rational life cycle financial planner would think about the problem.[909] It is also very close to what we have recommended in Chapter 3. Of course, a rational life cycle financial planner would understand all the risk-return tradeoffs and be fully aware of – and be comfortable dealing with – the tensions between different principles, in particular, the tensions between having flexible access to the pension pot, the degree of investment risk assumed, and the risk of running out of money before dying.

The problem is that most NEST members will be 'humans' rather than 'econs'. As we have mentioned previously, pension flexibility is completely inconsistent with the philosophy underlying auto-enrolment in which the disengaged member is required to make no active decisions between the age of joining and the age of retirement. It is unlikely that such people will suddenly become engaged when the time comes to make a decision about their pension pot.

We therefore face the following conundrum. Flexibility requires drawdown and drawdown is risky.[910] Lifetime income security requires deferred annuities and these are expensive. Further, as Tom MacPhail warns: 'The Financial Conduct Authority is unlikely to look kindly on a solution which involves putting disengaged investors into a risk-based retirement income solution'.

Can this conundrum be resolved? We do not believe it can be. Both DC savers and regulators are going to have to accept that there is a fundamental difference between a retirement income that is based on investment (drawdown plus deferred annuities) and a guaranteed income that is secured through an insurance policy (annuities). We have recommended that the best solution is to use a decision tree with a small set of default pathways that guide people towards one of these two key solutions, depending on the member's circumstances and risk appetite. We believe that both defaults are valid. This is unavoidable – and the fact that there can be more than one 'right' answer is just something the Government, regulators, practitioners and customers have got to get used to.

Given the blueprint, there are clearly issues about which we need to know a lot more:

[909] David Blake, Douglas Wright, Yumeng Zhang (2014) Age-Dependent Investing: Optimal Funding and Investment Strategies in Defined Contribution Pension Plans when Members are Rational Life Cycle Financial Planners, *Journal of Economic Dynamics & Control*, 38, 105–124.
[910] There is, of course, guaranteed drawdown – which is not being offered by NEST – but that is expensive.

- In order to achieve the report's ambitions, more clarity will be needed in particular on the underlying asset mix designed to produce real returns of up to 6.5% consistently over a 20-year investment horizon
- Very little has been said about charges, except for the general statement:

> *Defaults need to provide good quality and value for money. Value for money is a likely consequence of solutions being designed to deliver good outcomes for the majority, as opposed to being highly bespoke and more expensive to deliver. Solutions that work for the majority will also benefit from economies of scale'.* [911] *In due course, we would expect NEST to produce a good value benchmark for charges in each of the three component parts the decumulation strategy, i.e.:*

  - *Low withdrawal cost (some providers are charging a lot for withdrawals, either as a an annual % or per withdrawal – £240 for each withdrawal has been noted in the press)*
  - *Low AMC/TER for the default drawdown fund, plus*
  - *Competitively priced late-life annuitisation process/rates*

- NEST is anticipating that the markets will begin to offer deferred annuities. This, we believe, would be an excellent idea, but if this does not happen, will NEST self annuitise, i.e., offer deferred annuities internally? This is possible and they could also be reinsured as in the Rothesay arrangement with Zurich in May 2015[912]
- The launch date (2017 at the earliest) and whether the product would be available to non-NEST savers. NEST does, of course, have the luxury of being able to wait until the time is right. As a new scheme, member pots are tiny at present (£200 on average). This plan will probably make more sense in 10 to 20 years' time
- The blueprint does not address how to engage with scheme members such that the fundamental conflicts concerning their attitudes to pensions are resolved:
  - members want secure inflation-proof income that is not impacted by stock-market falls, but, at the same time, they want flexibility, the ability to pass on their pensions when they die and the possibility of benefiting from stock-market gains
  - members value choice, but are often unwilling to engage with their savings options and make complex and significant decisions about how to access their savings

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[911] NEST (2015, p.4) *The Future of Retirement: Guiding Principles for the Design of Retirement Pathways for the Automatically Enrolled Generation*, March; http://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/guiding-principles.pdf

[912] http://www.ftadviser.com/2015/05/12/pensions/annuities/zurich-offloads-bn-legacy-annuity-book-KkvYMXrPhsan0AyU3fKICP/article.html

    - It is not clear why the first phase begins at 65 – what happens to people who want to start drawing from their pension pot at 55?
- Nor is it clear why the drawdown surplus at age 85 should be converted to cash – could it not be used to provide an enhanced income above and beyond that from the deferred annuity?

In terms of a wider role for NEST in the decumulation market to help improve retirement outcomes:

- From 2017, it can accept transfers in, which means that existing members will be able to consolidate previous pension pots through NEST (always taking care to check older policies for terms and conditions such as exit penalties and guaranteed annuity rates). This is very important if NEST intends to become a national aggregator scheme for DC decumulation. The question is: will transfers-in be classed as single contributions and attract the 1.8% contribution charge? We assume NEST would prefer the answer to be 'no' which further delays the payment of the Government loan; the ABI and all major AE providers would want the contribution to attract the 1.8% charge. The DWP and the Treasury are also likely to be divided on this point, with the former supporting the continued growth of their 'baby' and the latter concerned about repaying the Government loan
- Employers and providers that do not wish to offer scheme drawdown directly could use NEST as a third-party provider for this function
- The self-employed and employees with employment contract that are ineligible for auto-enrolment could be encouraged to use NEST for both accumulation and decumulation purposes, putting them on a level playing field with employees who already have access to a low-cost, well-designed accumulation and decumulation scheme via their employer.

However, it is clear from the wide spectrum of opinions expressed by respondents to our consultation, that a move on NEST's part into the wider market would be greeted with both very positive and very negative responses. Despite this, we make the following recommendation:

Recommendation 5.1: A role for NEST in decumulation

We recommend that NEST should be allowed to compete in the decumulation market from 2018 to provide a value-for-money decumulation product in the same way that it has in the accumulation market. This would enable NEST to set a competitive charge and governance standards that would provide a market benchmark.