The role for NEST in the pensions market under automatic enrolment

4

Summary

This chapter considers whether an intervention like NEST is necessary to support the introduction of automatic enrolment.

We start with the presumption that the scope for automatic enrolment remains broadly in line with that proposed by the Pensions Commission and examine what drives profitability in the existing pension market and how automatic enrolment will impact on profitability. This analysis supports the Pensions Commission's argument that there is a supply gap in the existing pensions market and that this gap persists despite the introduction of automatic enrolment. In fact, automatic enrolment counter-intuitively decreases overall profitability in the market, due to the inclusion of new savers with low salaries, low contribution levels and relatively high job churn.

In this chapter we look at a range of options to fill the supply gap within the current scope, including ensuring universal coverage through subsidising pension providers or putting administrative arrangements in place to reduce costs for providers. In Chapter 7, we go on to consider whether changes in the scope of the reforms can reduce this supply gap.

Some stakeholders suggested alternative models that would use more of the existing industry infrastructure than NEST, typically by creating a new government funded front end to handle member joining and contribution collection, but utilising existing infrastructure to manage member accounts. Whilst we have seen nothing to suggest that these models could not succeed at lower build costs than NEST, we have seen no proof of concept. A key factor in drawing our conclusions on such options was timing. The Pensions Commission set out the basic choice the nation faces: save more or work longer or pay higher taxes. They saw the "save more" option as critical to ensure the large "baby boomer" generation save now for their own retirement, rather than asking the smaller generations that follow to pay for them through taxation. Probably inevitably, the programme has already taken longer to implement than the Pensions Commission envisaged, but to delay it further, maybe by up to another three years, while alternative models are investigated and built, would be problematic.

While we would be naturally cautious of recommending such a major intervention into the market, supported by a government loan, as NEST, we see no alternative if automatic enrolment is to be introduced at anything like the currently envisaged scope on anything like the currently envisaged timescale.

4.1 Introduction

There are currently around 56 thousand private sector occupational pension schemes in the UK. Twenty insurers hold the vast majority of this business, both in terms of policies and assets under management[61]. Nevertheless, pension coverage has reduced among private sector employees, standing at only 37 per cent in 2009. Around 6.5m people save into non-employer sponsored schemes. Automatic enrolment is intended to encourage more people to save for retirement. Following the introduction of workplace pension reforms in 2012, the DWP estimates that around 5 to 9 million people will be newly saving or saving more for retirement.

For automatic enrolment to succeed, every employer and individual must be able to access pension saving. However, the Pensions Commission's analysis concluded that there will be a significant number of companies or individuals who are unprofitable for the pensions market to serve at a reasonable cost to members, typically small companies and lower earners. This being the case, automatic enrolment would be unworkable. The Pension Commission's solution to this was the National Pension Savings Scheme (now NEST).

This Chapter is designed to ask whether NEST is necessary. This is important, first because it is initially funded by a government loan and, second, because it will inevitably have some effect on competition in the market. We therefore look at what the private sector can profitably do, and at other potential supply models for automatic enrolment.

Section 4.2 discusses the supply gap in the current pensions market. Section 4.3 then examines the impact of introducing automatic enrolment on profitability. Section 4.4 looks briefly at stakeholder pension schemes. Section 4.5 examines the lessons from international experience and the Pensions Commission's rationale in recommending a National Pension Savings Scheme. Section 4.6 looks at alternative ways of filling the supply gap.

4.2 The supply gap in the pensions market

The planned introduction of NEST into the pensions market is predicated on the assumption that it would not be profitable for the existing pensions industry to service certain segments of the market at an acceptable cost to members. For the purpose of our analysis, we have adopted a benchmark for acceptability of the typical levels of charges enjoyed by today's pension savers, with an absolute upper bound of the stakeholder charge cap of 1.5 per cent for the first ten years and 1.0 per cent thereafter.

4.2.1 The Pensions Commission's conclusions

Profitability in the pensions market depends on the balance between the cost to the provider in setting up and running the scheme, and the revenues received. Planning horizons are also a crucial factor. For example, whether a firm will be profitable for a provider in 5, 10, 20 or 40 years will influence their willingness to supply.

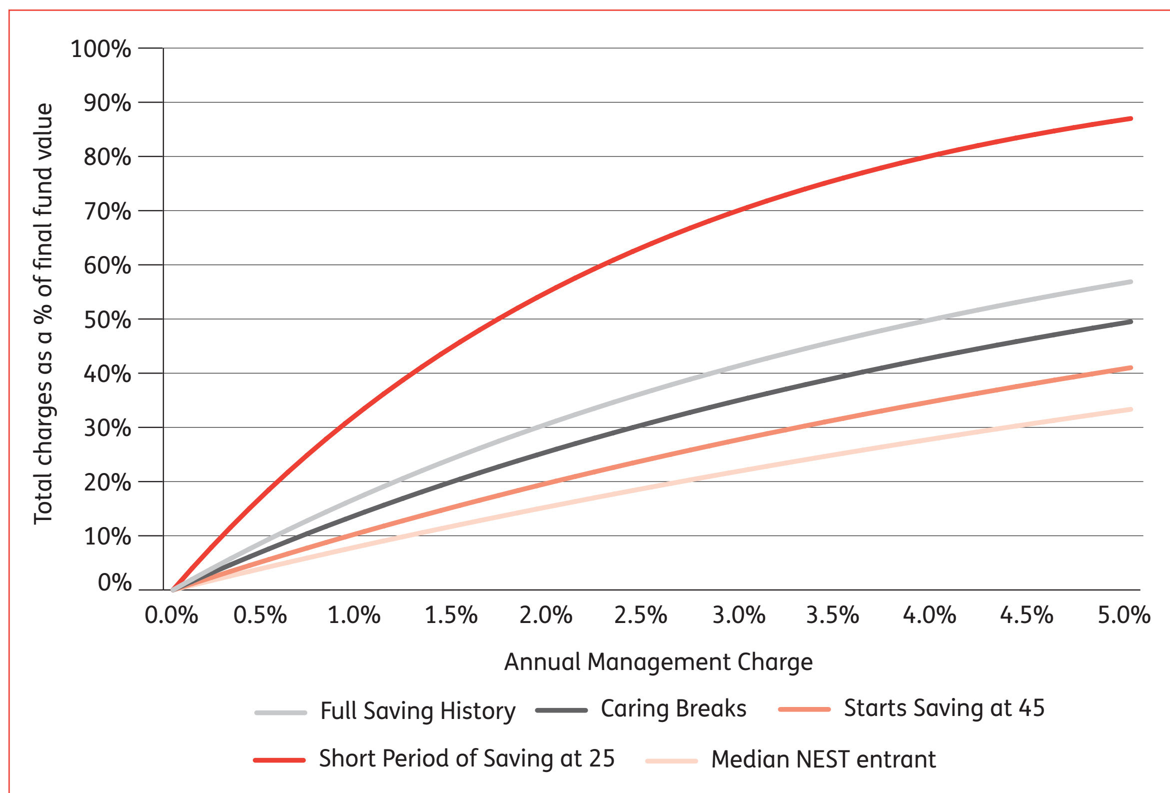
61 ABI, 2009, Money in Funded Pensions in 2008.

Revenues come from charges, typically on funds under management via an annual management charge (AMC) but also to a lesser extent on contributions via contribution charges (CC). The amount of revenue received depends on the amount contributed into the scheme, which in turn depends on the number of members, their salary levels and contribution rates. Schemes with low member turnover, and hence high proportions of active to inactive members, also tend to be more profitable (see Section 4.3).

Where a scheme is not predicted to be very profitable, the insurer will tend to charge at a higher rate to ensure that they are able to recoup the costs of setting up and running the scheme. However, the Pensions Commission argued that there is a supply gap in the pensions market. Even under the stakeholder charge cap of 1.5/1.0 per cent annual management charge, significant numbers of median earners working in small and medium sized firms are unprofitable or only marginally profitable for the pensions market.

Furthermore, the Pensions Commission argued that to achieve good member outcomes charge levels should be much lower than 1.5/1.0 per cent. Charge levels have a significant impact on lifetime savings. Chart 4.1 shows that a median earner with a full savings history who pays a 0.5 per cent AMC would lose nine per cent of their total fund value. By contrast, at the 2.5 per cent level, the saver would lose 37 per cent of their funds. Even at the stakeholder charge cap, a median earner with a full savings history will lose over 20 per cent of their total fund value.

Chart 4.1 Total charges as a percentage of final fund value



Source: Department for Work and Pensions modelling.

To address the supply gap whilst achieving good member outcomes, the Pensions Commission therefore recommended the creation of a low-charge national pension savings scheme (now NEST). Based on examples of costs in UK occupational pension schemes, and international comparisons such as the Swedish Premium Pension Scheme[62], the Pensions Commission proposed that an AMC of 0.3 per cent should be achievable, due to two key factors: reduced costs and greater persistency. The Pensions Commission envisaged a reform environment in which all eligible workers without current workplace pensions are automatically enrolled into the national pension savings scheme (or branded-provider model equivalent). This would reduce the need for marketing and advertising to attract members, would eliminate the need for regulated advice, and would ensure economies of scale in the scheme, significantly reducing costs. Under this system, the Pensions Commission also assumed that the majority of individuals enrolled into the national pension savings scheme would end up saving into this (rather than individual employer schemes) for the majority of their saving life. This very high persistency would dramatically reduce the costs associated with administering inactive pension pots.

4.2.2 Changes since the Pensions Commission's recommendations

The pensions landscape has altered significantly since the Pensions Commission reported, partly but not wholly due to the economic downturn:

- The Government Actuary's Department forecasts of longevity show further increases in life expectancy since the Pensions Commission's report.
- Pension coverage has reduced amongst private sector employees, falling from 42 per cent in 2005 to 37 per cent in 2009, and from 7.9 million savers in 2005 to 7.0 million in 2009. This includes a million fewer members of defined benefit schemes (down from 3.8 million to 2.8 million) which is not offset by the small increase in defined contribution/group personal pensions or stakeholder pensions (up from 4.0 million to 4.1 million)[63]. The proportion of employers offering any workplace based pension scheme fell from 33 per cent in 2007 to 27 per cent in 2009[64]. This was characterised by a reduction in the proportion of employers who offer an occupational scheme and a reduction in the proportion of employers who offer a workplace stakeholder pension.
- The economic downturn was initially associated with a fall in equity returns, but there was then a strong recovery, such that many pension investment funds have fully recovered the losses from the early part of the downturn.
- The FSA launched the Retail Distribution Review (RDR) in 2006. It is currently in a consultation phase. The review is very broad and aims to address persistent problems in the retail investment market. In its latest consultation paper, the RDR proposes a ban on commission in the sale of personal pensions, including group personal pensions and a move to a fee-based system where employers will need to arrange to pay an upfront fee to an adviser (consultancy-based fees). The reason for this proposal is to make charges more transparent to employees and remove commission bias from the sale of contract based pension schemes.

62 OPSS (GAD) 1998 shows occupational schemes with 5000+ members operating at average costs far below 0.3 per cent; The Swedish system operates at 0.37 per cent for default fund investors, and 0.64 per cent for others, envisaged to fall below 0.2 per cent and to 0.33 per cent respectively by 2020.

63 Annual Survey of Hours and Earnings, United Kingdom 2005 – 2009, Office for National Statistics.

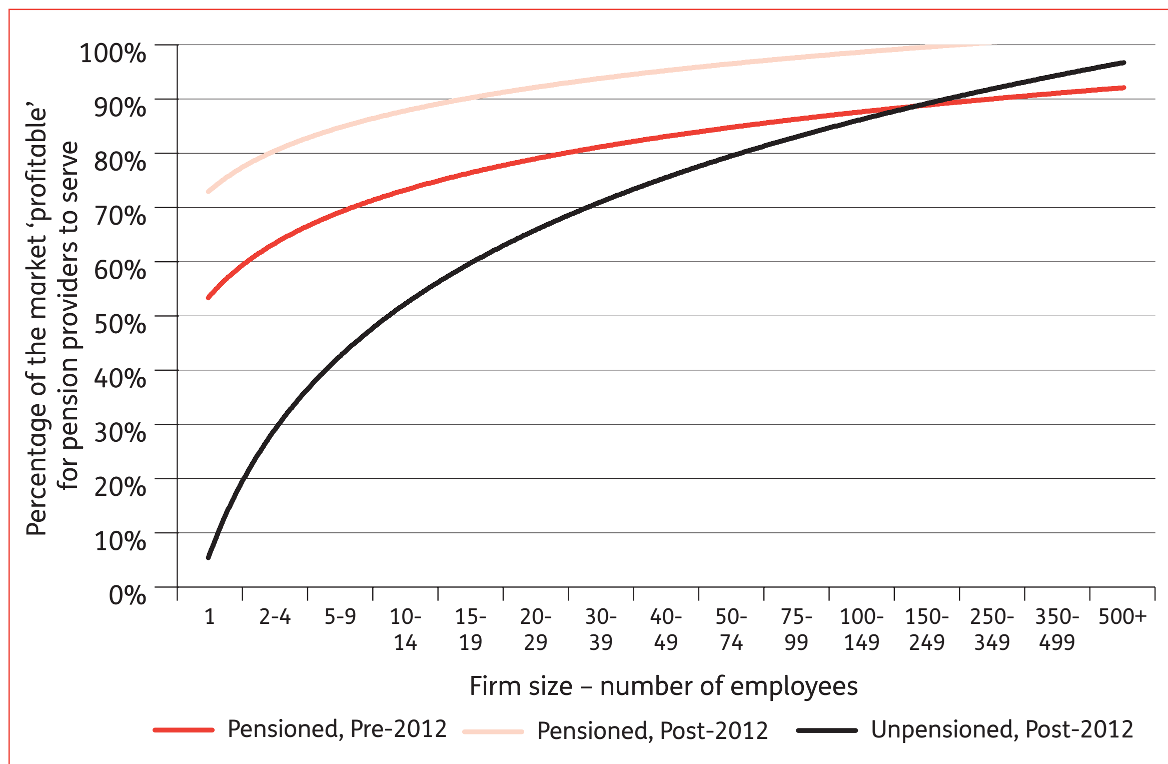
64 Forth, J and Stokes, L, 2010, "Employers' Pension Provision Survey 2009", Department for Work and Pensions Research Report No 687.

4.3 How will automatic enrolment affect profitability in the market?

Automatic enrolment is intended to solve the problem of low pension take-up and increase both the numbers of people saving for retirement and the average rates of contributions. As a consequence, it is expected to increase overall pension contributions without significant effort on the part of providers, so companies will reap higher revenues without equivalent marketing costs. One might therefore have expected profitability across the market to increase after the introduction of automatic enrolment, reducing the supply gap.

However, DWP modelling shows that this is not necessarily the case. Chart 4.2 shows that employers who currently have pension schemes are highly profitable to the pension provider, as you would expect. After 2012, these firms become more profitable. However, firms that will offer provision for the first time after 2012 are much less profitable than those firms that already had provision. Even at the relatively high charge levels shown in the chart, less than half of previously unpensioned firms with ten employees or fewer will be profitable. If the charges are reduced, the difference becomes even more pronounced (see Chart C.3.1.1 in Annex C).

Chart 4.2 Profitability of firms before and after the introduction of automatic enrolment, under Stakeholder Charge Cap



Source: Department for Work and Pensions modelling.

In order to understand these results, we have examined the different factors that influence profitability. This next section discusses cost and revenue drivers in the pensions market and presents modelling which explores the different factors influencing profitability. The discussion and analysis presented is at scheme level[65].

4.3.1 Costs

Pension providers incur costs through the following activities:

- Selling the scheme to the employer.
- Setting up a scheme: smaller schemes are typically more expensive because the same fixed cost must be borne by fewer members.
- Marketing the scheme to members: costs are lower where employers facilitate joining mechanisms like automatic enrolment or streamlined joining processes, so reducing providers efforts to 'persuade' employees to join the scheme; incentives like employer contributions to the scheme also make a difference.
- Enrolling each individual in the scheme: although smaller than the costs above, these are still relevant, since a member who makes low or no contributions to their fund will represent a net cost to the scheme provider.
- Maintaining each fund: this will vary and is generally low, but in cases where members are difficult to contact, for example if they move abroad without leaving a forwarding address, costs can quickly escalate when providers require decisions on, for example, how to vest the fund.
- Processing members who leave the scheme.

4.3.2 Revenues from charges

These costs are typically recovered from revenues generated through the levying of charges, typically on funds under management (AMCs) but also to a lesser extent on contributions (CCs). Some employers meet some or all of the charges on their scheme independent of members' funds or contributions.

The size of the revenues generated from charges depends upon a number of factors:

- Number of members in the scheme; larger numbers allow the provider to distribute the fixed costs.
- Members' average salaries.
- Contribution rates (from members and the employer).
- How long members contribute for: providers are more likely to recover costs on savers who contribute significant amounts throughout the life of a fund, or concentrate contributions early, than on those who defer savings until late in the fund's life, even if contributing large amounts at this time.

65 One important caveat is that profitability is not black and white for pension providers. A provider may look at profitability across its whole book rather than on a scheme only basis. Some schemes or firms may in isolation be unprofitable but providers take on the business for other reasons, for example as a halo brand to attract future business.

Schemes where contributions are expected to be relatively low will be sold at higher charge levels to ensure the provider is able to recoup the costs of selling, setting up and running the scheme. Currently, providers selling workplace personal pensions argue that the introduction of the stakeholder pension charging cap has forced down prices across the market and that there is a de facto universal limit of an annual management charge (AMC) of 1.5 per cent[66]. A survey in 2009 found that charges in contract-based workplace personal pensions tend to be around a 0.4 – 0.59 per cent AMC excluding commission, or around one per cent where commission is paid to an intermediary. The majority of trust-based occupational pensions also tend to have a single overall charge, in the region of one per cent of funds, though some schemes use contribution charges or a combination of AMCs and CCs instead. However, in three out of four trust-based schemes, the employer pays some or all of the charges, rather than members[67].

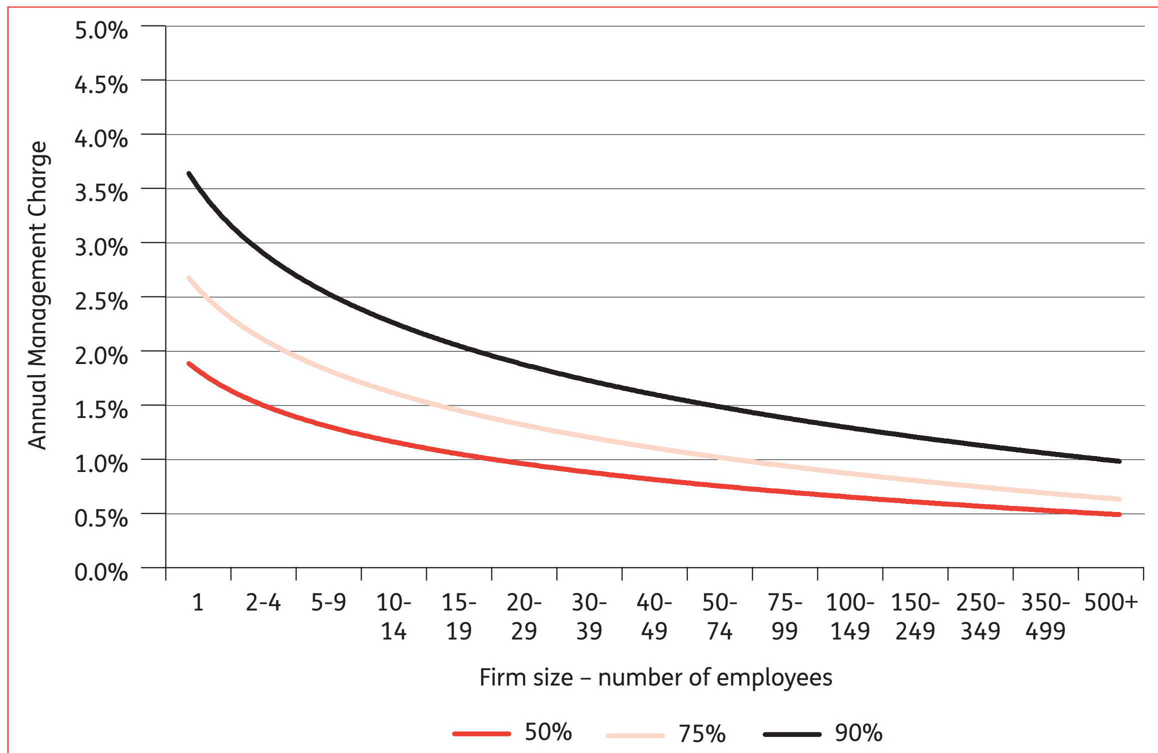
In deciding whether or not to take on business, and then on the charge levels for that business, a provider will consider the balance between the costs and the expected revenues, taking into account the timespan for recouping costs. Providers say that they try to find out information about an employer's workforce, for example size, age, turnover, salary, in order to inform this decision as far as possible. There are few firms that could not in theory be profitably served by the pensions market, but there are many firms for whom the charge levels needed to recover costs would be unacceptably high. It would seriously undermine the Pensions Commission's carefully crafted settlement of boosting employee savings with compulsory employer contributions if the benefit of the employer matching was effectively lost to exorbitant charges. When charge levels become so high, individuals might even respond by saving elsewhere (for example in ISAs) or not saving at all, at which point the revenue base recedes, necessitating higher charge levels and the market for this group collapses.

Chart 4.3 shows the charge levels necessary to make different percentiles of the employer market (by firm size) profitable after the introduction of automatic enrolment. For example, in order for three-quarters of micro employers to be profitable, providers would have to charge an AMC over 2 per cent.

66 Wood, A, Leston, J and Robertson, M, 2009, "Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries", Department for Work and Pensions Research Report No 591.

67 Source: Croll, A, Vargeson, E and Lewis, A, 2010, "Charging levels and structures in Money purchase pension schemes: Report of a quantitative survey", Department for Work and Pensions Research Report No 630.

Chart 4.3 AMCs required to make 50 per cent, 75 per cent or 90 per cent of the market profitable



Source: Department for Work and Pensions modelling.

4.3.3 Analysis of key factors determining how 'profitable' schemes are

Some key characteristics of employers and their workforce will determine scheme profitability. Annex C.3 presents new DWP modelling of profitability, with the following key findings.

- A very strong positive association between employer size and the likelihood that a company scheme will be profitable. Around three quarters of employers who have 20-29 employees would be profitable at the stakeholder charge cap, compared with only around one quarter of employers who have 2 employees.
- A very strong relationship between average pay and profitability. Employers who offer an average salary below £18,000 a year are very rarely profitable to pension providers.
- A clear relationship between job churn (in terms of the number of individuals leaving an employer per year) and profitability. Just under half of employers with the lowest job churn are profitable, compared with less than ten per cent of the employers with the highest job churn.
- A strong relationship between current pension provision, with 91 per cent of employers who currently offer any kind of pension scheme to some of their employees expected to be profitable after automatic enrolment, compared to only 23 per cent of employers with no pension provision.

This modelling fits with pension providers' comments around the determinants of profitability, which highlighted member salary and job churn as being key factors[68].

4.3.4 Understanding the impact of automatic enrolment on profitability

Chart 4.2 showed that introducing automatic enrolment makes previously pensioned employers more profitable, but that many previously unpensioned firms remain highly unprofitable. There are two opposing influences on this outcome. Firstly, automatic enrolment causes participation in pension schemes to increase significantly. Chapter 3 suggests that membership might rise from around a third on average to three-quarters or even higher, without corresponding marketing costs to persuade individuals to join. This will increase revenues overall and increase the number of members over which the fixed costs can be spread.

However, this is countered by the second effect, which relates to the characteristics of members brought in through automatic enrolment. At the employer level, we know that the majority of unpensioned companies are micro employers. These employers tend to offer lower average salaries and experience higher employee churn than large firms (see Chapter 3). The analysis in Chapter 2 shows us, at the individual level, that those who have chosen to save into a pension tend to earn more than those who are not saving, are older, and thus can be expected to move jobs less frequently. Putting this together, we can see that the population of savers brought in by automatic enrolment is expected to be concentrated in small firms, to earn less and move jobs more frequently, and thus be less profitable than those already saving.

In addition, the introduction of a low-cost scheme such as NEST is expected to drive down management charges, and thus overall revenues. This effect will be less pronounced for existing schemes than for new ones, both because they are already likely to charge at a more competitive rate prior to the introduction of NEST and because a lower charge rate is needed to attract new customers than to retain existing ones. New members are also less likely than existing members to contribute more than the minimum required under the Pensions Act 2008, and are potentially more likely to opt out, generating higher administration costs for the pension provider.

These effects are illustrated by Chart 4.2, which compared the profitability of previously pensioned and unpensioned firms after the introduction of automatic enrolment. From the pensions industry's perspective this is potentially concerning, since the overwhelming majority of unpensioned employers have fewer than fifteen employees.

This analysis chimes with the views expressed by pension providers, who are not convinced that automatic enrolment will necessarily result in an overall increase in revenue or profitability. They argue that increases in numbers of members does not necessarily translate into significantly higher contributions overall, due to the low level of minimum contributions. Further, they are concerned that new revenues would be offset by the administrative burden of enrolling and un-enrolling high churn individuals with low salaries and contribution rates. Consequently, some providers feel that automatic enrolment may not lead to increased revenue, even in existing schemes [69].

68 Wood, A., Leston, J. and Robertson, M., 2009, "Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries" DWP report number 591.

69 Wood, Leston and Robertson, 2009, "Pensions industry responses to the workplace pension reforms: Qualitative research with pension providers and intermediaries", Department for Work and Pensions Research Report No 592.

4.4 Stakeholder pension schemes

Since 2001, employers with five or more relevant employees have had to offer a stakeholder pension scheme to their employees, or provide another scheme of equivalent or better quality. These schemes are bound by prescribed quality standards, including a charge cap of 1.5 per cent for the first ten years, thereafter moving to one per cent. The aim of this policy was to provide easy access to simple, low-cost pension schemes to low and middle income groups. The stakeholder charge cap was initially set at one per cent, and then later increased to 1.5 per cent for the first ten years and 1 per cent thereafter when distribution and regulatory costs in the stakeholder market turned out to be higher than expected.

There have been successes and failures with the stakeholder initiative. On the plus side, it has driven down charges and improved value to the customer, particularly amongst workplace defined contribution schemes and for individuals who make their own decision to save for retirement. But, despite quickly achieving over one million members, stakeholder schemes never achieved the level of uptake expected and created an advice gap in the pensions market. There have also been instances of small firms experiencing difficulty in finding a pension provider genuinely willing to serve them.

The advice gap, in particular, has meant that too many people are not saving for retirement, despite being offered access to simple, low cost stakeholder pension schemes. Financial capability amongst key groups of concern is relatively low[70], and simply informing people of the need to save, and ensuring they can find a suitable savings vehicle are not sufficient to make people act. For this reason, the Pensions Commission argued for the introduction of automatic enrolment to increase the numbers of people saving for retirement, as set out in Chapter 1.

4.5 Meeting the demand created by automatic enrolment: learning from other countries and history

We now turn to the question of how to meet the demand created by automatic enrolment, and whether the existing market, including stakeholder schemes, is able to cope.

Before our appraisal of possible options, in Section 4.5, we first examine what we can learn both from international experience of pension reform and from earlier decisions in relation to reform in the UK.

4.5.1 International experience

A number of countries have implemented private pension reform, but there is no single perfect comparator to UK workplace pension reforms. New Zealand, Australia and Sweden bear most comparison to components of UK reform[71].

70 Atkinson, McKay, Kempson and Collard, 2006, "Levels of Financial Capability in the UK: Results of a Baseline Survey". Prepared for the Financial Services Authority by the Personal Finance Research Centre, University of Bristol.

71 Collard and Moore, 2010, "Review of International Pension Reforms", Department for Work and Pensions Research Report No 663.

The KiwiSaver scheme, introduced in New Zealand in 2007, provides the closest comparison to the UK workplace pension reforms. KiwiSaver schemes are provided by banks, insurance companies and fund management companies, who administer and manage members' savings. Fifty-two KiwiSaver schemes were on offer from 30 providers in 2009. Seventy-seven per cent of KiwiSaver membership and 78 per cent of KiwiSaver funds are held by nine schemes. Six of these are the default funds to which people are allocated if they are automatically enrolled and do not make an active choice or their employer has not nominated a scheme for them to join.

In Australia, the Superannuation Guarantee was introduced in 1992, which is a mandatory employer contribution to a private pension plan, which employers have to pay quarterly either directly to a regulated superannuation fund or via a commercially-operated clearing house. The plans may be operated by the employer, industry associations, financial services providers or by individuals themselves. At the end of September 2009, there were 457 superannuation funds for people to choose from in the four main fund categories (corporate, industry, retail and public sector). There were another 421,671 small funds with fewer than five members, most of which are self-managed.

In Sweden, a new pension system was introduced in 1999, which consisted of an earnings-related element based on a system of notional accounts, and a small mandatory contribution to the Premium Pension, a defined contribution pension scheme. There are approximately 85 companies involved in the Premium Pension market, providing over 700 separate funds.

Charging structures and their regulation vary internationally. There is no prescribed fee structure or level of fees for KiwiSaver pension plans in New Zealand, although the KiwiSaver legislation prevents providers charging 'unreasonable' fees. The fees charged by default fund providers were negotiated by the Government and prescribed for each provider in their Instrument of Appointment.

Superannuation accounts in Australia have fixed commission fees, fees on contributions and an asset management fee. While these are not capped, the regulatory rules prohibit any administrative fees that exceed investment returns being charged on accounts with a balance of less than AUD 1,000 (£500), except in periods of bad investment returns (i.e. a period where investment returns are less than administration costs).

In Sweden, Premium Pension plans attract an asset management fee, which is not capped. Sweden is considered to have relatively low fee levels, at less than 0.5 per cent of assets under management. This is largely due to the clearing house system operated by the Premium Pension Authority (which became part of the Pensions Authority), which negotiates management fees directly with providers. The Premium Pension Authority also operates a discount schedule, based on the principle that the marginal cost of investing additional funds decreases the greater the volume of Premium Pension assets invested. As the scale of business increased over time, therefore, the required fund discounts increased as well. As a result, the total costs are estimated to fall from 0.45 per cent of assets under management in 2007 to 0.23-0.27 per cent by 2020.

There is little evidence of the impact of private pension reform on the pensions industry and national pensions markets. There is some evidence of a concentration of provision among a small number of large providers, although whether this had impacted on competition was unclear. These are often the default funds and are characteristically conservative in their investment approach. Established providers with networks of offices and large sales forces have been able to increase market share, but at an increased cost to the pension saver. The results of evaluations in New Zealand in 2008 and early 2009 suggest that it is still too early to say with confidence what the effect has been.

There is no direct equivalent to the establishment of NEST internationally. The number of providers involved in delivering private pensions under reformed systems varies considerably, which leads to the question of why NEST has previously been considered to be necessary by the UK Government, when no such scheme exists elsewhere. We will look briefly at the history of this decision, before turning to stakeholder views and then examining other supply options in more detail.

4.5.2 Government history of model choice decision: National Pension Savings Scheme and provider choice models

In designing NEST, DWP considered and consulted on two main operational models (along with variations on these core approaches):

- National Pension Savings Scheme (NPSS) model: in this model, proposed by the Pensions Commission, the scheme would be administered by a single organisation which would manage and service members' accounts and interface with fund managers. Competition under this model would be for contracts, rather than individual members.
- Provider choice model: rather than a single organisation having oversight of the system, a limited number of branded pension providers would offer schemes and administer the accounts. Savers could choose their preferred provider or be allocated to a default provider.

It was assumed that both models would involve some initial cost to government, either in setting up the NPSS or in providing an administrative 'front end' for the provider carousel to collect and channel individuals' contributions appropriately.

Whilst no option perfectly fulfilled all the evaluation criteria, at the time the NPSS model was assessed by DWP as preferable on four key criteria:

- Coverage: the more limited choice prescribed by the NPSS model is more appropriate for consumers and thus more likely to maximise participation. Evidence shows that individuals commonly lack confidence with financial decision-making and can be deterred by too much choice.
- Rate of return: whilst set up and administration costs looked broadly similar across the models, DWP's analysis suggested that the provider choice model would be 20-25 per cent more expensive, due to the cost of marketing to individuals.
- Operational efficiency: the NPSS model is simpler for both employers and members, who only have to deal with one organisation.

- Risk: regulators have suggested that any approach delivered by branded providers is more likely to generate inappropriate business practices, since providers have financial incentives to act against members interests by, for example, competing aggressively to capture market share.

4.5.3 Stakeholder views after the Pensions Commission reported

At the time of the decision on delivery model, the only options under consideration were the NPSS or the branded provider choice model, or variations on these. Responses from the pensions industry supported the branded provider choice model (or variants), arguing that this model offers the opportunity to re-use existing infra-structural assets, and thus avoid unnecessary investment and help reduce implementation risk. Increased choice and personal responsibility were also cited as arguments for this model, along with the benefits of more efficient competition. By contrast, employer and worker representatives tended to support the NPSS model on grounds of lower costs, greater simplicity and better protection for members.

4.6 Meeting the demand created by automatic enrolment: our appraisal

The current proposed approach of establishing NEST would represent a significant intervention into an existing commercial market. We would only support such an intervention if:

- The existing market was unable to deliver the outcomes necessary to support the policy ambition of addressing the long-term pension savings deficit; and
- It was not possible to achieve those ambitions through a less interventionist market solution.

Earlier in this chapter, we considered the existing industry's profitability, how this might be affected by the introduction of automatic enrolment and the extent to which the pensions industry was able to meet the demand created by the current proposed scope for automatic enrolment. This analysis supports the Pensions Commission's conclusion that there is a "supply gap" as a result of the existing industry being unable to profitably supply a suitable low cost product to all employers seeking to automatically enrol their employees.

In Chapter 7, we go on to consider whether changes to the scope of automatic enrolment might support the pensions industry in supplying a suitable product to a greater proportion of the post automatic enrolment demand. Here, we draw conclusions on the breadth of scope of automatic enrolment that could be delivered without market intervention, and the circumstances in which a supply gap would remain.

In this section, we consider the various interventions that might be made, should the scope for automatic enrolment be such that a supply gap remains. This analysis allows us to consider how NEST might ensure such a supply gap is met and how it compares with alternative interventions. In doing so, we consider the impact of each option on individuals, employers, the pensions industry, costs to Government and programme delivery. We summarise what stakeholders have told us (Section 4.6.1) and assess the options we have identified to meet any supply gap in the pensions market, including NEST (Sections 4.6.2 to 4.6.8).

Any strategies to increase supply to meet the demand created by the current automatic enrolment policy must look to increase the profitability of the market, either through increasing revenue, or decreasing costs for pension providers, or both. However, we feel that the options should be constrained by a maximum charge level. Any system aimed at improving access to pension schemes for low and median earners that nevertheless allowed unlimited charges on members would fundamentally lack credibility, and would not be in the public interest, and we do not want to lose the advances in value for money that have been gained in the UK over the last ten years.

Overall, regardless of the charge structure, we feel that charge levels exceeding an equivalent to the current stakeholder charge cap would result in unacceptably poor outcomes for savers, and that, ideally, charges would be below even this level. Our analysis of supply options is therefore based in part on their ability to deliver acceptable charges, and our modelling is conducted on the basis that charges do not exceed a maximum of the stakeholder cap (1.5 per cent AMC, declining to 1 per cent after 10 years).

With NEST in the market, we would expect providers to compete with charges in the range 0.3 per cent to 1 per cent AMC equivalent. Qualitative research conducted by DWP in 2008 shows that providers do not typically expect the reforms and the introduction of NEST to impact upon the largest trust-based occupational pensions to any significant degree[72]. However, there is an expectation that the reforms (and NEST in particular) will have considerable impact on the workplace personal pension (WPP) market. NEST will provide competition at the small and medium employer end of the market. We believe that the more progressive pension providers will raise their game to meet the competition, to the benefit of the employees being automatically enrolled. Pension providers will tailor their response according to profitability, so the smallest and least attractive firms will probably find NEST offers them best value, whilst "higher-end" employers will benefit most as pension providers compete to secure them over NEST.

4.6.1 Stakeholder views now

As a part of this review process, we sought to consult with as many interested parties as possible, including holding seminars and individual meetings, and through a call for written responses. We asked specifically for ideas on how to meet demand in the pensions market.

The responses were generally in favour of retaining NEST, across consumer, employer and industry groups. Overall, NEST was seen as the best proposition for providing for low and middle income groups at a low cost, with the added benefit of diminishing the burden on employers of sourcing appropriate pension provision. Consumer groups, in particular, strongly preferred an independent not-for-profit body to manage any new pension scheme.

72 Wood, A, Leston, J and Robertson, M, 2009, "Pensions industry responses to the workplace pensions reforms", Department for Work and Pensions Research Report No 592.

The majority of stakeholders were also strongly in favour of retaining an October 2012 start to the implementation of the reforms. We regard this as particularly important in the light of the demographic situation. The large "baby boomer" generation need to save more for their own retirement otherwise the smaller generations that follow will have to pay higher taxes to provide for the baby boomers in retirement. Demographers generally define the baby boom generation as those born between 1945 and 1966, which means that the first baby boomers are already starting to retire. Any further delay to automatic enrolment could conflict with the Pensions Commission's demographic argument. The current broad approach and timescales are backed by a broad consensus and already have a strong delivery momentum. Stakeholders see NEST as well advanced in its development and infrastructure, and feel it would not be possible to deliver alternative approaches in time to support implementation in the necessary timeframe. Discussions with Ministers have confirmed that they share a desire to make early progress in tackling the savings deficit. For these reasons, we have assessed supply options on their implications for the delivery of the reform programme, as well as their impact on individuals, employers and the pensions industry.

Further, there were very few suggestions that the pensions industry would be able to provide universal coverage for the target group under the terms of the Pensions Act 2008. There were some suggestions that the pensions industry might be able to meet demand if the scope of the target group was significantly changed, and some mentions of "well regulated master-trusts" as an option. However, even under an amended scope, low charge rates were seen as a deterrent, and it was felt that the pensions industry is not cohesive or united enough to provide a holistic pension solution to less attractive savers. Thus, apart from a few respondents, the general message was that the economics of the NEST proposition are not viable or attractive enough for the private pensions industry to be drawn in. Nevertheless, we have explored in Chapter 7 whether any combinations of options might render the market sufficiently attractive to providers to enable a wholly industry based supply solution under automatic enrolment.

4.6.2 Free market response: no systematic changes to current market

The least interventionist option would be to harness existing provision. Section 4.4 touched on the existing statutory duty on employers who have at least five relevant employees to designate a group stakeholder scheme for their workforce. Stakeholder schemes could be seen as an appropriate pension savings medium for low to median earners under automatic enrolment.

Coverage and costs to individuals

Despite the reduced selling costs and greater take up rates associated with automatic enrolment, it would not be profitable for providers to sell to all companies or individuals at charge levels around the stakeholder cap. The DWP's profitability analysis shows that less than half of all micro employers would be profitable at this level. Micro employers comprise nearly seven in ten of all employers, covering 12 per cent of the total workforce. Thus it is likely that, under a free market option, around 800,000 employers would find it difficult to access pension provision, affecting 2.3 million workers.

The present programme solution to the supply gap is to impose a public service obligation on NEST forcing it to take all-comers, however unprofitable. Attempting to apply a public service obligation to the whole pensions market would not be a viable option. The pensions industry would undoubtedly object very strongly, and any attempt to enshrine such a move in legislation would be difficult and likely to attract judicial review. A universal public service obligation could significantly distort competition in the market, as smaller and niche providers would eventually be forced out, leaving a handful of the largest companies to share the market. Even the larger providers may be disadvantaged if they are selected disproportionately by unprofitable employers, and could struggle to ensure their business remains viable.

In the absence of, or even with, a universal public service obligation the only way to ensure 100 per cent coverage of the eligible population (as it is currently defined) through the open market would be to allow providers to charge significantly higher rates than we think acceptable, leading to poorer outcomes for savers. Among those able to access pension provision, the lowest earners are likely to attract the highest charges, whilst those with higher salaries will be able to access pensions with lower costs, since they are more profitable to the market. Thus the lowest earners at whom the pension reforms are targeted would be disproportionately disadvantaged under a free market model.

Impacts on employers

In addition to the impacts on individuals, the free market option would potentially present an increased burden on employers, who would find it harder to access pensions, and would need to put more time and effort into securing provision. The smallest employers would find it hardest to secure a scheme, have the least experience and confidence with pensions, and are concerned about the responsibility of taking such decisions on behalf of their employees.

4.6.3 Subsidise providers

An alternative to allowing unlimited charges would be to cap charging, but subsidise providers to offset the costs of the least profitable segments of the market. This could be done through a general subsidy, for example tax relief, or a subsidy just to compensate those companies serving unprofitable employers; the latter option would be the fairest, most cost-effective way to ensure that the government subsidy was used appropriately.

Any subsidy would need to take into account the economies of scale enjoyed by providers, along with the degree to which they were serving unprofitable segments of the market. There would need to be continuous monitoring to ensure that subsidies continued to be focused in the right way. Offering subsidy to some providers but not others would raise state aid concerns, which would need to be considered.

This option would entail ongoing costs for government, both in terms of the subsidy itself and in setting up and running the necessary systems to monitor provider activity in the market and distribute the subsidy accordingly. However, this would be at least partially offset by savings on the cost of building the new infrastructure for NEST. Overall, subsidising the pensions industry as it stands or even with the widespread introduction of master-trusts would not involve the same economies of scale as a single scheme with a public service obligation. Therefore, in the long term, the ongoing subsidies are likely to exceed the costs associated with setting up NEST.

4.6.4 Limited number of default providers sharing the public service obligation

This option would involve applying the public service obligation to a small number of pension providers who would join a default 'carousel'. Any employer who was unable – or unwilling – to find a pension provider on the open market would be randomly allocated a provider from the carousel, potentially via a simple gateway on The Pension Regulator's website.

Coverage and impacts for consumers

The application of a public service obligation would ensure that every company and individual would be able to access pension provision. Furthermore, the provider carousel would, in theory, capture the employers we would otherwise expect to use NEST, supplying sufficient volumes and thus economies of scale to deliver low charge levels.

However, one of the key perceived benefits of NEST is that it is simple, portable, and designed specifically to meet the employer duties; employers may be positively attracted to the scheme for these reasons, including those whom it may be profitable for the open market to serve. For example, some very large employers with existing provision may seek to use NEST for certain segments of their workforce, running this in parallel with their own schemes. In the absence of the NEST branding, it may be the case that these more profitable employers disperse across the entire market, as there is little to attract them to the carousel. In this case, the provider carousel would be left with just the least profitable companies, and may need to increase their charge levels to compensate, leading to poorer outcomes for members. If the provider carousel had higher charge levels than schemes on the open market, employers may be deterred from using it for fear of making choices that lead to poorer member outcomes. This would then exacerbate the problem of only the very least profitable business going to the carousel.

Impacts on the pensions industry

The competition impacts of this option depend on the extent to which providers on the carousel are able to use the cost reduction of government-provided administration, or the revenue from a compensatory subsidy, in their general business. It would be difficult to identify whether a carousel provider was using these features exclusively for the business they received through the carousel, or used the cost reduction to more keenly price or reduce costs in open market areas.

Programme costs and delivery

It may be difficult to attract providers to compete to be part of the carousel, due to the unprofitable nature of this business, although we would envisage that any provider on the carousel would also operate in the open market and obtain profitable market share that way. However, we might need to consider offering incentives to providers to belong to the carousel. For example, Government could provide an administrative front end to the carousel to manage the collection of contributions, reducing costs for those providers; alternatively we might consider a direct subsidy, entailing an ongoing cost to Government.

Legislatively, the establishment of a carousel would be complex to design and implement, and further analysis would be needed to establish how this might be achieved. The costs to government of this option would comprise the costs of any necessary subsidies to providers on the carousel. If Government were to supply an administrative front end there would also be substantial cost implications in terms of the set up of new IT and administrative systems, and the ongoing running costs.

It is also difficult to envisage how such an approach could be developed and implemented in a way that supported a stable introduction for the reforms in October 2012. We would anticipate that the start date for the reforms would inevitably be delayed.

4.6.5 Free market response: systematic establishment of Master-trusts

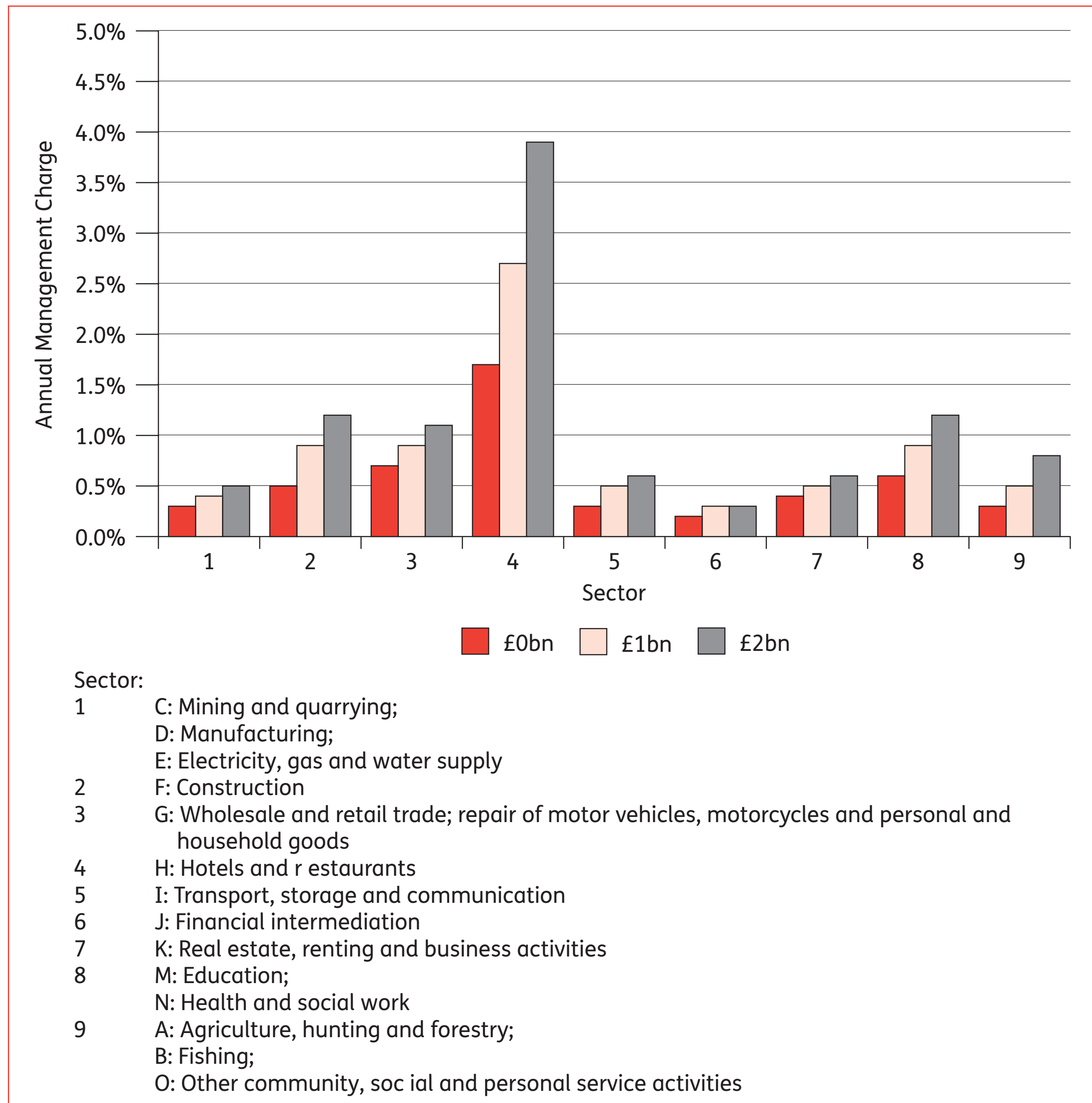
Master-trusts are trust-based occupational schemes which seek to generate economies of scale by operating on a multi-employer basis, removing employer-specific trustee duties, whilst retaining a single trustee structure. A product provider will have set up the trust and installed a group of trustees to run it. The provider will also supply administration and investment services to the trustees. These schemes tend to be set up from scratch explicitly with the purpose of serving multiple employers, who may be entirely unrelated. A super-trust is a similar concept, but involves grouping existing employer-sponsored occupational pension schemes. These employers will be grouped together based on region, location, industrial sector or on a national basis. The schemes will then have centralised administration functions and one board of professional trustees.

Master-trusts are more complex than normal pension schemes to administer and are not currently widespread in the UK; research by Deloitte for DWP in 2008 identified only three master-trusts at that time, run by Standard Life, Prudential and Legal & General. Whilst these are examples of schemes run by pension providers, master-trusts could be also set up and run by employee benefit consultants (EBCs).

Coverage and impacts on individuals

The key benefit of these arrangements is that they facilitate greater economies of scale and allow the schemes to offset higher revenues from more profitable employers against the costs of less profitable members. Capita Hartshead research figures suggest that schemes with more than 50,000 members cost around £15-£20 per member whilst schemes with fewer than 1,000 members cost £150 per member. More detailed analysis demonstrates the potential scale of the effects of pooling. Chart 4.4 illustrates the charge levels needed to generate 'break even' points (zero aggregate net present value) when pooling employers by industry. Chart C3.3.1 in Annex C shows the charge levels needed by employer size. In particular, across all sectors other than hospitality, pooling would allow schemes to operate at charge levels substantially lower than 1 per cent AMC.

Chart 4.4: Impacts of pooling employers by sector: AMC levels needed to generate £0 NPV, £1bn profit or £2bn profit



Source: Department for Work and Pensions modelling.

In the long term, master-trusts can potentially provide access to pensions at lower charge levels than single schemes under a free market option. However, setting up master-trusts involves significant development and administration costs. Existing pension providers would need to set up and run the master-trusts in parallel with their legacy business, requiring two separate administrative platforms. Deloitte's research estimated the cost to a provider of adapting their existing systems as between £2-20million, and the cost for setting up an entirely new system of around £100million (an EBC or trade body choosing to set up a master trust would likely incur similar costs). These costs would need to be recouped via member charges, and so it is not clear that this would be a more cost-effective option for savers in the shorter term.

We have some anecdotal evidence that employers are looking to move to master-trust arrangements in response to the reforms, in order to take advantage of short service refund rules in occupational pension schemes.

Impacts on employers

Master-trusts offer an advantage to employers when compared with traditional occupational schemes, since the employer does not bear the cost and administrative burden of setting up the scheme. However, some employers may still find it difficult to access provision, with the associated costs and burdens of trying to access pensions. It is conceivable that some employers may still be unable to purchase a pension scheme and become non-compliant through no fault of their own. It would be more difficult for The Pensions Regulator to enforce compliance in this context.

Impacts on the pensions industry

On the face of it, this option would appear to entail very little competitive distortion, since it is an entirely market-based solution. However, pension providers have expressed significant concerns that the widespread establishment of master-trusts could destabilise the market. They worry that employers might be strongly encouraged to reconsider their existing pension provision by intermediaries (who stand to earn fees or "consultancy charges" on each re-sale of a pension scheme[73]). The consequent market churn could be damaging to pension providers, who rely on the long term "embedded value" of pension products, based on expectation of future profits.

To some degree, the success of a super-trusts model is also dependent on the market remaining fairly static. Pooling allows providers to offset the costs of less profitable business with the revenues from more profitable business only where the provider is able to retain the more profitable end. New providers entering this market would look to attract the most profitable business away from existing master-trusts, upsetting the fine balance enabling low charges across the market.

Programme costs and delivery

It is difficult to see how, in the absence of other levers, Government could persuade pension providers (or other organisations) to bear the costs, and potential risks, of setting up master-trusts solely to achieve sufficient economies of scale to allow them to take on unprofitable business. It may be necessary to provide incentives to encourage this approach, for example through a subsidy. This is likely to be lower than the subsidies that might be required under a general free market option, due to the greater economies of scale offered by master-trusts. It is, again, difficult to envisage how this approach could be developed and implemented in a way that supported a stable introduction for the reforms in October 2012.

As with the general free market option, this option could present higher compliance costs if The Pensions Regulator is operating in a more challenging compliance landscape, plus the costs of any necessary incentives.

73 Under the Retail Distribution Review changes, commission will be replaced by "consultancy charging."

4.6.6 The Danish Model: a national collective defined contribution scheme

One model that has been cited by some stakeholders in the context of UK pension reform is Denmark's ATP scheme, which has very low charge levels. ATP was established as a statutory pension fund in 1964, and amended in 2008. It is a mandatory scheme with both employer and employee contributions, providing a hybrid benefit with some guarantees and additional benefits on top depending upon scheme performance. ATP covers almost the entire Danish population representing 4.6 million members and 160,000 employers.

As a risk-sharing collective defined contribution scheme, ATP does not have charges that are strictly comparable with annual management charges in group personal pension schemes. Nevertheless, ATP scheme costs are very low. There appear to be four key factors driving these costs down.

- State funding: set up costs were met by the Danish State and there are no legacy financing costs; all costs are just from running the scheme.
- Compulsion: the scheme is mandatory and therefore incurs negligible marketing costs. It also does not have to process opt-outs or opt-ins, further reducing costs.
- Economies of scale and pooling: not only is the scheme very large, but it captures the entire market, allowing ATP to offset costly members against more profitable ones, with no risk that other providers may cream off the most profitable business.
- Cost reduction by eliminating administration: the scheme piggy-backs on existing government tax administration to obtain information about members and calculate contributions, avoiding duplication and increasing accuracy, especially in processing small employers.

We have been asked by some stakeholders to consider whether government could replace the NEST proposition with a collective defined contribution scheme, and whether we could achieve even lower charges this way. Looking into this question, we have identified two significant barriers, which we will address in turn.

First, the Danish ATP scheme is run by a single provider, covering almost the entire working population, and forms a core part of the Danish state pension system. The effects of pooling and economies of scale help to drive down charges, and are possible because ATP effectively has a monopoly; contributions to the scheme are compulsory. Further, the scheme does not have to cover legacy financing costs, since these were met by the state.

The only way to exactly replicate this in the UK would be to have a state-sanctioned provider take over the existing workplace pensions market as well as taking on a public service obligation for all new members to form a single, state-subsidised scheme. We contend that introducing this kind of system is not possible in an economy with such a highly developed financial sector as the UK. The alternative to a state-sanctioned monopoly would be to have a number of collective schemes, i.e. master-trusts or supertrusts, as discussed in Section 4.6.5.

Second, two significant contributors to Denmark's low costs are absent in the UK. Not only is their scheme compulsory for all employees, but the costs of administering small employers are drastically reduced by the use of the tax system for data flows and calculations. An equivalent use of HMRC data systems (obviating the need for new administrative systems) would enable other schemes, including NEST, to have lower charge levels.

We understand that this would require a significant overhaul of HMRC's systems, since it does not currently have the capacity to administer pension savings. In addition, PAYE records are only reconciled annually, when tax and National Insurance Contributions are checked and finalised to ensure they are correct, based on the individual's earnings that year. This means that there would be a significant delay between an individual making a contribution and that money being invested, resulting in a loss of investment growth. We note that HMRC have recently consulted on improvements to PAYE systems that could address some or all of these difficulties. However, our understanding is that such changes are unlikely to be available to support the administration of workplace pensions within any short timeframe and, therefore, would involve an unacceptable delay to the introduction of automatic enrolment.

It is also important to remember that Denmark's ATP scheme is a very large, mature pension scheme, established over forty years ago. In 2010, funds under management were in excess of $100bn. As such, it is not directly comparable with the NEST proposition, as a brand new scheme.

4.6.7 Development of alternative infrastructure

A number of stakeholders have suggested that there may be ways of developing an alternative infrastructure to support the reforms that would allow the pensions industry to offer low cost workplace pension products to a much wider range of employers. The ways in which this infrastructure was envisaged varied in the detail, but ideas centred one or more of three themes:

- Establishing a common and automated process for collecting information and contributions from employers.
- Maximising the capacity and capability already established within the pension industry.
- Utilising other existing infrastructure, for example the information collected by HMRC for tax purposes or the process for assessing and collection in the PAYE system.

Some stakeholders pointed to potential developments to the PAYE system as a possible future infrastructure that could support both the collection of income tax and contributions to a workplace pension.

Having considered the various proposals put forward, we concluded that:

- While there were conceptual opportunities to develop cross-industry infrastructure that could reduce costs and involve a smaller state initiated intervention to the pensions market, these would involve a fundamental change to the programme and delay implementation of automatic enrolment by perhaps up to three years.

- The proposals have not benefited from the extensive work that has already been invested in proving the NEST concept. Several alternative proposals might appear feasible on the surface, but none can command the high degree of credibility that NEST has on its delivery.

The majority of stakeholders are strongly in favour of retaining an October 2012 start to the implementation of the reforms. This is seen as important, both to ensure an intervention is made as quickly as possible to address the consequences of demographic changes resulting from the ageing of the "baby-boom" generations, and because the current broad approach is backed by a strong consensus and has a strong delivery momentum.

Our conclusion is that exploring alternative infrastructure would be likely to delay implementation of the reforms by at least three years without any guarantee that this would lead to a more optimal outcome.

4.6.8 The current policy: NEST

NEST is intended to meet the supply gap by serving all those companies and individuals who are unable to find pension provision elsewhere. NEST will be a trust-based occupational pension scheme, managed by a corporate trustee, and will operate broadly in the same way as any other defined contribution occupational scheme. The scheme will have a public service obligation to accept any employer (and any qualifying employee) that wishes to use it.

NEST has been designed to meet the needs of a particular target group, including smaller employers and individuals who tend to have lower earnings and lower financial literacy, and are most vulnerable to loss. For these reasons, NEST incorporates a number of protective features, including low charge levels and a default investment strategy which is likely to be cautious to match the risk appetite of the target group. There will be an annual contributions limit and a restriction on the transfer of benefits into and out of NEST, in order to focus the scheme on its target market.

NEST is able to achieve low charges for groups that the existing market finds it difficult to serve through a simple product proposition, supported by a technology driven delivery model, in conjunction with improved persistency of saving amongst its members and economies of scale.

The costs of establishing and operating NEST will ultimately be met from member charges. However, until revenue streams are established, the set up costs and early years running costs of NEST will be funded by a Government loan. This results in a peak financial commitment to NEST from Government of between £0.5bn and £1bn, which will be repaid over a period of around two decades.

Coverage and impacts on individuals

The provision of a new scheme with a public service obligation will ensure 100 per cent pension provision across the market. More than this, the Pensions Commission's key argument for the need for a National Pension Savings Scheme (now NEST) was to supply universal access to pension saving at a low cost to the member. They argued that low costs would be achievable through high membership, and thus economies of scale, along with very high persistency. They anticipated that the National Pension Savings Scheme would have sufficient coverage that most workers would end up saving in the National Pension Savings Scheme for a significant chunk of their working lives, typically through different employers at different times, reducing the costs associated with member churn.

DWP estimates put the number of people who will be automatically enrolled between 10-11million; the Pensions Commission's expectation was that most of these would end up in the National Pension Savings Scheme (now NEST). There is now a greater emphasis and expectation of employer choice of scheme and the anticipated take-up of NEST now is around 1 million employers, resulting in between 3-6 million members. These volumes are still very high and allow the scheme to make savings through economies of scale, in spreading fixed costs across a large number of members. In addition, NEST will be limited in the extent to which it can compete with the existing providers thus restraining marketing and advertising costs.

The question of persistency of savings is more complex. While the majority of employers are expected to use NEST, this will affect less than half of all those automatically enrolled, so the Pensions Commission's expectation that most employees would move from job to job and remain within NEST may not hold true. We expect that most micro and small employers will use NEST, but in order for the argument to hold, employees within these firms would have to work within the same sized employers for the majority of their career, which is not the case in practice. The analysis in Chapter 5 (Table 5.4) shows that the vast majority of employees working for smaller employers move into firms with more employees and the overall proportion of employees who continue to work in the same size firm increases with size. Employees who work for employers with only one employee were the least likely to stay working in the same size firm, 32 per cent, compared to 44 per cent of employees working for employers with four or fewer employees and 55 per cent of employees working for an employer with 19 or fewer employees[74]. Nevertheless, the persistency gains will still be greater for NEST than under scenarios where NEST does not exist, since employees are likely to return to NEST more often than they would any other single scheme.

The combination charge level chosen for NEST is broadly equivalent to an AMC of 0.5 per cent, comparable with charge levels currently available to higher earners and those in large workplace schemes. Low to median earners, the target market, are very unlikely to be able to access pension provision at these rates under a free market option.

74 The 20 per cent sample cut in 2007 and 2008 will have an adverse affect on results and have been excluded. The results are based on un-weighted data, and restricted to the main job. The results marginally under-estimate the number of employees staying in smaller employers from one year to the next because the sampling frame slightly under-represented smaller firms, and because employer growth (workforce increasing from 4 to 5 employees) will be classified as a move between employers. Missing data due to an employee either leaving employment, or employer non-response will result in a marginally under-estimate the number of moves between employers over the 10 year period. The net effect is unknown. For this reason, great care should be taken when interpreting the results.

Impacts on employers
The existence of a low-cost scheme with a universal public service obligation reduces the burden on small employers who might otherwise expend considerable time and effort in identifying a scheme willing to serve them at an acceptable cost. Small employers have expressed particular concerns about how they will choose a pension scheme to meet their new statutory duties. Provided that NEST is clearly signposted to small employers as having a public service obligation and having been designed with the needs of small employers in mind, we believe that these very real concerns can be mollified.

Impacts on the pensions industry
NEST has a contribution cap and a restriction on transfers into and out of the scheme in order to focus it on the supply gap and so that it does not replace the existing pensions market. Nevertheless, it is likely that NEST will attract segments of the market that could be served by the existing pensions industry, even at relatively low charge levels. The charge levels in NEST may also drive down charges across the market, in the same way as the stakeholder charge cap has done. Providers have expressed concern that this imperative to compete on charge levels will further limit their market penetration.

Programme costs and delivery
NEST is on course to support the delivery of the reforms from October 2012. Upfront funding via a loan results in a peak financial commitment to NEST from Government of between £0.5bn and £1bn, which will be repaid over a period of around two decades.

4.6.9 Restrict NEST to certain customers

Whilst there was support for NEST in stakeholder feedback, criticism from the pension industry in relation to NEST tends to focus on Government financial support for a scheme that will compete for segments of the market that could be served by the existing industry, rather than solely plugging the "supply gap". One option therefore might be to limit NEST's membership by preventing the scheme from accepting certain types of members.

The most straightforward way to do this legislatively would be to modify the scheme order to restrict NEST with regard to the size of employer it is able to accept. So, for example, restricting NEST to only taking on employers with fewer than 20 workers.

This option would preserve the current market outcomes, since pension providers would be free to compete for profitable business on charges and products as they do now, without facing competition from a large, government-financed scheme. At the same time, individuals would still have access to a low-charge scheme that offers protection to the most vulnerable savers.

Coverage and impacts on individuals
Defining the threshold for this restriction would be challenging since employer size is only a rough proxy for profitability and there is a risk that a supply gap could persist. Providers reported in DWP research that they look at a wide range of factors to estimate profitability, including member salary and contribution rates, workforce age profile, employee churn, employer commitment to pensions and industry sector[75].

75 Wood, A, Leston, J and Robertson, M, 2009, "Pensions industry responses to the workplace pensions reforms", Department for Work and Pensions Research Report No 592.

We assume that in the absence of NEST the open market would charge up to the current stakeholder cap. However, with NEST in existence and offering relatively low charges (albeit it may not be able to deliver charges as low as a 0.5 per cent AMC equivalent given a restricted membership), we would expect this to influence the rest of the market in driving charge levels down. It is conceivable therefore that there could be some employers who are too large to go to a restricted version of NEST, but who are still deemed to be unprofitable by the pensions industry.

Further, the current assumption is that NEST will be used by smaller firms, but also by large firms who wish to use it for the lower-paid or short-term segments of their workforce. Restricting NEST's ability to accept business will inevitably limit employers' options and flexibility in terms of their pension provision. This also potentially results in poorer outcomes for lower-paid workers in large organisations, who would not be accepted by NEST and thus may be subject to higher charges on the open market.

Impacts on employers
Restricting NEST to certain categories of employers or individuals presents a confusing message. There is a risk that this could damage the contingent consent and thus compliance levels, simply because employers are unsure of their duties and options. Further, there is the risk that some employers could find it very difficult to access pension provision and become non-compliant unintentionally.

Programme costs and delivery
Amending NEST in this way would require changes in secondary legislation, which could be completed before the planned implementation in October 2012. However, there would be wider implications for the scheme administration arrangements, which may result in delays to implementation. Restricting NEST's membership to unprofitable business is likely to affect the scheme's ability to pay back the Government loan, and could even mean that the scheme would need ongoing subsidy.

4.7 Conclusion

Starting from a proposition of wanting to provide relatively low-cost pension provision for individuals without very significant reductions in the scope of coverage of automatic enrolment, our profitability analysis supports the Pensions Commission's argument that there is a supply gap in the existing pensions market. This gap persists despite the introduction of automatic enrolment; in fact, automatic enrolment counter-intuitively decreases overall profitability in the market, due to the inclusion of new savers with low salaries, low contribution levels and relatively high job churn.

We conclude that it would be wrong to ask the existing pensions industry to cover the whole of the automatic enrolment population, either through higher charges or through some form of subsidised charges. A significant risk in asking the pensions industry to cover a new and, at current charge levels, unprofitable client group would be substantively higher charges. These would impact both on new savers and potentially lead to higher costs in the wider market place. This would undermine the hard won gains in terms of value for money that we have seen over the last ten years.

By contrast, we believe that the introduction of NEST will both offer good value to its target audience and provide a high benchmark for the rest of the pensions industry. We hope that, in many areas, existing pension providers will raise their game to meet this competition, providing further improvements in value for money for those being enrolled into pension saving.

The Pensions Commission set out the basic choice the nation faces: save more or work longer or pay higher taxes. They saw the “save more” option as critical to ensure the large “baby boomer” generation save now for their own retirement, rather than asking the smaller generations that follow to pay for them through taxation. Probably inevitably, the programme has already taken longer to implement than the Pensions Commission envisaged, but to delay it further, maybe by up to another three years, while alternative models are investigated and built, would be to undermine seriously the basic concept of “save more”.

Mindful of the need to make progress, we reject alternative proposals that would add a number of years to the timetable and which do not have the strong certainty of delivery that NEST has built up to date.

We conclude that NEST is a necessary part of ensuring universal access to a pension scheme at acceptable cost to the member. This view is also held by the majority of stakeholders who responded to our consultation during the review. Consumer and employer groups see NEST as a necessary and integral part of the reforms, and even industry representatives do not feel that that they can – or would wish to – provide a workable alternative to NEST.

We believe that NEST will be a force for good, setting high standards for the UK’s pension provision, and working with the pension industry to improve customer outcomes.