National Employment Savings Trust

"Still no clear view of the road ahead"

Exaxe White Paper

Author: Tom Murray

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Introduction

Pension providers are already deep in planning for the changes that will be wrought by the arrival of personal accounts, (now rebranded NEST – the National Employment Savings Trust), in 2012.

The arrival of NEST amounts to a complete revolution in pension planning for ordinary people who currently make no pension provision. This is causing a lot of midnight oil to be burned as pension providers try to predict the likely landscape post-2012 and to position themselves for it.

However, these plans may all be for naught as there are straws in the wind that current government plans may be in trouble.

RDR effect on the pensions market

The scale of the change to the UK pensions market is unprecedented, with huge amounts of middle and lower income people being auto-enrolled into pension schemes which will dramatically increase the size of the market.

Although opting out is possible, the automatic re-enrolment after every 3 years will result in it being harder to stay out than to go in. As a result, by 2020, the majority of the working population in the UK will be a member of a pension scheme of some sort.

The setting up of NEST by PADA, the Personal Accounts Delivery Authority, is a dramatic change, with a government sponsored body becoming a player in the market with the pension providers for the first time. The government scheme is likely to be very popular with smaller companies on the basis that it is being run by a not-for-profit trust and that joining it will ensure legal compliance by default.

The other new factor is the compulsory contributions from the employers. The likelihood over time is that it will drive down wages across the smaller firms, where there is currently least pension provision, leading to lower paid workers opting out in order to maintain their living standards.

NEST administration

The government set up PADA, a non-departmental public body, to introduce the NEST scheme. PADA therefore had responsibility for negotiating with suppliers to provide a scheme administration system at low cost. The cost factor is particularly important as the goal of the project is to provide a low-cost pension to ensure that the return on the small amounts of individual pension savings would not be decimated by a high charging structure.

PADA initiated a tendering process and opened negotiations with four prospective administrators in June 2009. By October, this was down to three, as the Danish provider ATP decided that the scheme "did not fit with its commercial model". In November, the number dropped to 2 following the withdrawal of Logica UK and was quickly followed by the retirement of Great-West Retirement Services.

This leaves TATA Consultancy services as the only bidder left. The winning bidder is expected to be selected by next summer.

The withdrawal of three of the bidders shows that the cost structure is too inhibitive for the administration to be commercially viable. As it is, with six months of negotiations with a single supplier, the costs are undoubtedly under pressure and whether PADA can hold the line remains to be seen.

Pension providers currently working to produce a model which can compete at the same cost level as the government scheme should now wait to see what finally emerges. PADA will not want to lose the final bidder, indeed in this time-frame they cannot afford to, and so the final cost base that emerges may well be looser than that currently proposed.

NEST charging structure

In the meantime, the charging structure for the pension has been published. After market research, which indicated that either a single contribution charge or a single fund charge was the best solution to allow the target market to understand the charging structures, NEST have decided to completely ignore this and go with a combined structure of both a temporary contribution charge of 2% and an annual management charge of 0.3%.

This is the option most decisively rejected by their target audience. It has to be remembered in this context that complex charges are off-putting to the average person and that in 2003 it was discovered that 47% of adults (i.e. 15 million) in the UK are unable to reach the numeracy level of expected of an 11 year-old.[1] This decision of PADA to go with a complex charging structure will confuse the very people it is supposed to be targeting.

Unknown contribution charge

The length of time the contribution charge will remain in force is still unknown, probably because the only supplier left in the game is in a position to resist any efforts to push the price down.

The theory behind the temporary contribution charge is to recover the set-up costs of NEST as quickly as possible by bringing in a larger earlier stream of income. There are a number of problems with this:

a) It is completely unfair to older members of the scheme as they are bearing the brunt of the set-up costs

b) It means that Illustrations are worthless as there can be no guarantee when the charge will expire

c) It makes it difficult for trustees to compare their current scheme with the government's new one in order to look after the best interests of their members

Indeed, Exaxe's internal research shows that this charging structure will mean that an individual has to be in the system for at least eight years before the charge starts to be a lower charge than if a single annual management charge of 0.5% had been chosen.

Of course, once the eight year point is passed, the total amounts charged rapidly reverses and it is a much lower charge. But for older workers within 5 years of retirement, the overall charge

[1] 'Skills for life' 2003, Department for Education and Skills, prepared by BMRB: a survey of 8,730 randomly chosen adults aged 16-65 http://www.dfes.gov.uk/research/data/uploadfiles/RR490.pdf

could work out much closer to a 1.5% annual management charge, which is steep by any standards.

This does give an opportunity to pension companies to segment the market as companies with charging structures more favourable to older employees will have a persuasive argument for employers with older workforces to adopt their solution, rather than to go for the NEST.

Existing Schemes

Where employers have existing schemes they can auto-enrol individuals into this scheme. However providers of these schemes need to be aware that employers who contribute more than the statutory 3% may use this opportunity to reduce their contribution level across the board and therefore the overall fund levels could take a hit.

Treasury reluctance

The core of the NEST program is the split of contributions:

- Member contribution – 4%
- Employer contribution – 3%
- State contribution – 1%

This envisaged a significant cost to the Treasury in order to boost individual and employer contributions and encourage pension savings.

While this may have long-term advantages in reducing state support for the elderly, it has a significant up-front cost for the Treasury. And in the current economic setting, short-termism is winning out.

Already, the recent decline in the fiscal position has resulted in a desire in the Treasury to postpone the full introduction of the system to avoid having new demands coming on-stream at a time when the costs of debt servicing are rising and tax returns are falling. The result of this was that the Chancellor, Alistair Darling conceded that employers can contribute only 1% to their employees' pensions for an extra year. This slower ramp-up of the system will mean that there will be less for the Treasury to match and it is estimated that it will save the Treasury £2.4 billion.

The temptation to further slowdown the full implementation of the NEST, and so delay the impact on the Treasury, is likely to be very strong as they battle to get government spending under control, irrespective of who wins the election.

Opposition support wavering

The concept of NEST was welcomed, with some reservations, by all sides of the house when it was first mooted. However, while the Conservatives were supportive of the principles of wider pension self-provision, they had considerable concerns regarding the approach to implementation that the Government was taking.

In particular, they were opposed to the co-dependence of auto-enrolment, compulsory employer contributions, and the personal accounts concept and are sceptical of any government body's ability to deliver another large scale IT project.

The Conservative's emerging views seem to be focused on separating out auto-enrolment, compulsory employer contributions, and personal accounts. They believe that the quickest way to start improving the pension environment is to move forward early with auto enrolment, ahead of the introduction of NEST. This would mean that current provider schemes would benefit from auto-enrolment while the creation of the NEST was underway. So far, the Conservatives have given no concrete indication on their views on compulsory employer contributions

What has been promised is an immediate review of the whole personal account program if the Conservatives win power on May 6th. Without trying to predict the election outcome, a Tory victory is a reasonable possibility and therefore it is possible, nay probable, that the entire basis of the project could be radically changed by the middle of 2010.

Conclusion

Given the uncertainty within the market and the current election campaign, it is difficult to be sure what will emerge as the ultimate personal account solution. It could be NEST as currently proposed or it could be a new version that takes elements of the existing scheme and creates a new approach. This makes it very difficult for companies to plan their response.

There are a number of key questions that Providers should be considering:

- Should they create qualifying schemes to compete directly with NEST or any alternative version?
- What is the likelihood that current schemes will auto-enrol non-members?
- Will employers drop their contributions down to the NEST level in schemes where it is currently higher?
- Will current scheme trustees try to switch their members across to NEST?

However there are too many doubts about what will finally emerge post the general election for providers to undertake decisive action at this point.

A victory for the Government should see the system retain the basic structure as at present, although the conclusion of the supplier deals could yet force changes on the charges side which could make the market more attractive for Life and Pension companies to target.

A Conservative victory would lead to an immediate review and could end up with auto-enrolment being introduced without the government scheme as a competitor, although it would be likely that there would be new regulations to tighten control over charges.

A hung parliament would mean that it could be even longer before it was clear what direction the pensions market was to take in the future.

Finally, any deterioration in the fiscal position could require the Treasury to make even more drastic cuts to public spending than is currently planned. In this case, it is far easier for them to cut pension contributions that haven't begun to be made yet rather than to reduce the number of police on the beat or close down hospital beds that already exist.

It seems that the only sensible approach is to hold fire and wait to see the result of the election before committing major resources to any response to NEST.

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With offices in **Ireland and the Netherlands**, we provide leading edge; front, middle and back office solutions specifically for life and pensions.

Exaxe's component based solutions **more effectively manage**; product development, quotations and illustrations, channel distribution and commissions management, administration, etc. They are **proven** and are in use in a wide range of client organisations.