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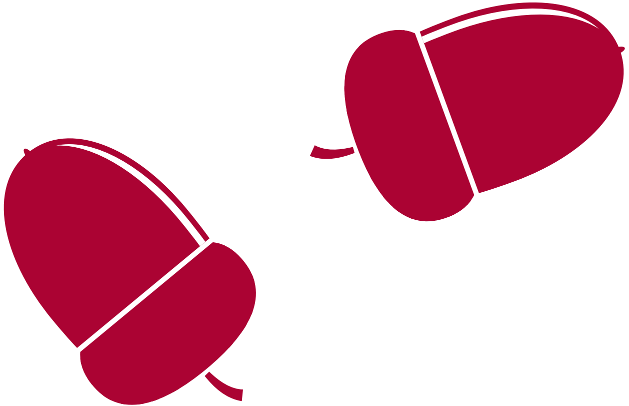

Fabian Ideas 633

by Gregg McClymont MP
and Andy Tarrant

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London SW1H 9BN
www.fabians.org.uk

Fabian Ideas 633

First published 2013
ISBN 978-0-7163-0633-7

Head of Editorial: Ed Wallis

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British Library Cataloguing in Publication data.
A catalogue record for this book is available from
the British Library.

Printed and bound by DG3, London, UK

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Pensions at Work, that Work

Completing the unfinished pensions revolution

by Gregg McClymont MP
and Andy Tarrant

We would like to thank the National Association of Pension Funds for their generous support of this publication.

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Summary

Nowhere does the idea of building a more 'responsible capitalism' resonate more strongly than in the world of workplace pensions. Pension saving should deliver two things. First, a reasonable income in retirement for savers on a cost-effective basis. Second, savings should be invested in a way that develops the long-term capacity of the productive economy. The current British workplace pension system is flawed in both respects.

The last Labour government adopted three vital private pension reforms. First, stakeholder pensions, which put pressure on providers to bring down the cost of workplace pensions. Second, auto-enrolment: companies must enrol all of their employees who are not currently contributing to a pension. Third, Labour created the National Employment Savings Trust (NEST), a low cost, high quality not-for-profit pension provider to serve these new savers.

Building on this revolution in workplace pensions will be of crucial importance to the next Labour government. This pamphlet sets out a series of reforms to ensure that the occupational pensions in which most Britons save, provide value for money. The authors see transparency of costs and charges, achieving scale and having effective independent trustees as amongst the key characteristics of a pension system that will deliver for savers. These reforms would not only lower the costs of saving, ensuring people a higher income in retirement, but also lead pension providers to favour the long-term, patient approaches to investment that are necessary to sustaining higher growth in the UK.

- Costs and charges: clarity and simplicity are required

Savings in pension schemes are invested by the scheme into range of assets. The eventual size of the pension pot is

not just a function of the extent of the contributions made and the gross returns achieved: the pension pot and the returns attract a range of costs and charges. These cost and charges can make a big difference to the eventual pension pot and thus retirement income. Their existence and levels have also been extremely opaque until now. This has permitted circumstances where in some cases too much income is being extracted by pension companies and fund managers.

Transparency is crucial. Labour will act and require a simple but comprehensive declaration of the costs of saving into a pension so that savers, or those acting on their behalf, can see the total costs.

- The importance of scale: pensions are not a cottage industry

The UK workplace pension industry is fragmented into thousands of schemes. These are often too small to operate at a level which will ensure that the members get the best possible deal. Modelling by the National Association of Pension Funds (NAPF) suggests that consolidation down to a smaller number of competitors would deliver considerable costs savings.

Making the costs and charges drawn from pension savers' pots transparent would allow those providers who wish to compete on low costs to do so in a way that has not been practicable when the true costs are obscured. Removing restrictions on NEST would allow it to compete with the private pensions industry. However, we need more than simply scale to remedy the problems of occupational pensions. Ensuring members capture the full benefit of scale means we need more schemes with independent trustees tasked to represent only the saver. But, equally, scale is important for ensuring that these trustees can be properly supported to deliver in the savers' interest.

- Reform of governance: for trust, trustees are needed

There are two forms of governance in UK pensions: trust-based governance and contract-based governance. There is a major difference in the legal duties which attach to those running pension schemes depending on the type of governance to which they are subject. In a trust, the ultimate legal responsibility of those running the pension scheme is to prioritise delivery for the members. In a contract-based scheme, the ultimate legal responsibility of those running the scheme is to deliver for shareholders.

Comparison of outcomes in both the UK and abroad suggests that members of trust-based schemes do better than members of contract-based schemes. If we want financial services that prioritise the savers' interest, fiduciary obligations deliver these. Fiduciary obligations will most effectively be delivered in pensions where pension schemes are managed by independent trustees.

Not all trustees are equal however: trustees of small schemes can be inadequately skilled and there has been a tendency of trustees to focus only on short-term returns. Schemes therefore need to have scale so they can provide trustees with the resources to do their job properly. The pensions regulator may also need revised powers to ensure that boards of trustees have the necessary skills.

- The regulatory system: ensuring pensions deliver for savers

The UK's regulatory system for occupational pensions, as far as defined contribution schemes are concerned, is not fit for purpose. There are two options for improving organisational effectiveness: either requiring enhanced co-operation between the existing bodies responsible for regulation; or

concentrating power in the hands of a single pensions' regulator. The current pensions' regulator's name belies its true status. It does not have sole responsibility for occupational pensions and it is inadequately empowered to conduct fully effective regulation.

The UK's current regulatory system for pensions does not adequately promote low charges, scale or effective governance for pensions. Labour's policy review is examining how best it can be improved.

- Lifting the restrictions on NEST: making the private sector compete with a low-cost non-profit making pension provider

The last Labour government set up the NEST to ensure that a low-cost non-profit making pension provider, capable of operating at scale and answerable to an independent board of trustees, would be available to firms auto-enrolling low and medium workers into a pension. However, the impact of NEST on the market has been constrained by restrictions imposed by government on its activity: a ban on 'transfers-in' from other pension schemes and a cap on the amount that can be paid in by any individual into a NEST account in the course of a year.

Labour has been campaigning for the restrictions on NEST to be lifted. An unfettered NEST would create greater pressure for lower costs and charges and provide an example in the market of the benefits of scale and of good governance.

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Foreword

Joanne Segars

October 2012 saw the start of a revolution in pension saving – auto-enrolment, the biggest shake-up in pension saving since the introduction of the state pension in 1906. Up to 11 million people – the majority of them low and moderate earners, around half of them women – will, for the first time, have the right to a pension scheme that comes with their job and that carries with it an employer contribution.

The effects of auto-enrolment will be rapidly felt. By the time of the next general election, 4.3m workers will have been auto-enrolled. Auto-enrolment is nothing short of a game changer in turning around the nation's pension fortunes.

Almost without exception, the majority will be auto-enrolled in defined contribution schemes. Already the dominant form of provision in the private sector, defined contribution will rapidly dwarf defined benefit provision – if not in assets, then certainly in numbers saving, by a ratio of around 8:1 by 2015.

But if we are to make the most of the opportunities presented by auto-enrolment, it is not sufficient simply to give people the *right* to a pension. In a world of quasi-compulsory pensions, there is a responsibility on government to ensure people are auto-enrolled into a *good* pension. That means one that delivers good returns and an adequate income.

In work commissioned by the NAPF, the Pensions Policy Institute (PPI) demonstrated the factors that help to deliver good pension outcomes from defined contribution schemes. These were: persistency of saving; saving earlier rather than starting late; saving more – either via employer or employee contributions; working later; shopping around at retirement for the best priced annuity; and lower charging schemes. The cumulative impact of these factors could triple the value of the final pension.[1]

The most effective way to ensure that these factors are in place is by creating the right pension structures and institutions for people to save in. Yet these institutions are almost entirely absent in the UK.

- **The UK's defined contribution pensions universe is highly fragmented and populated by a large number of very small schemes.** There are around 46,000 separate trust-based defined contribution schemes and many thousands more contract-based schemes. These small schemes are generally less able to access economies of scale in either administration or investment. As a result, they are likely to deliver poorer returns to scheme members, who will receive a lower pension for a given contribution when compared to members of larger schemes.
- **There is a growing governance vacuum amongst defined contribution schemes that disadvantages scheme members.** The pensions regulator suggests that small schemes are more likely than larger schemes to have poor standards of governance. However, most defined contribution schemes today are being established under contract and therefore have no formal governance arrangements at either employer or scheme level. This absence of an alignment of interest with scheme members has two potentially negative effects on member outcomes:

  a. There is no one to act 'on the members' side' to ensure high standards of service and value for money. The absence of this grit in the system is especially important in small employers where there is less likely to be internal expertise within the employer.

b. Schemes, and scheme members, are at risk of being exposed to 'provider capture' – in other words they may be tied into the products and systems of the commercial pension provider. Whilst these may have been the right offerings at the time the scheme was established, they may not be so on an on-going basis.

Unless these structural weaknesses of scale and lack of alignment of interest are challenged, auto-enrolment will fail to deliver the biggest prize of all: a defined contribution system that delivers good member outcomes, that is trusted, and gives good value for money where every pound of contribution counts.

It is the presence of scale *and* alignment of interest that is most likely to deliver good member outcomes. That is not to say that there are not good quality, well-run small defined contribution schemes – there are. But good member outcomes are most likely to be delivered when these two factors are present.

The NAPF argues that a new pensions structure is therefore required, one built around a small number of large, expertly governed schemes that can use their buying power to deliver value for money – and hence bigger pensions – for savers. We call these schemes 'super trusts'.

Already there are a number of schemes that display the characteristics of super trusts. But we need more of them. That will require government intervention on two fronts:

- First to create a new regulatory framework to give the pensions regulator powers to authorise super trusts, set the conditions within which super trusts should operate and criteria to ensure trustees were 'fit and proper'.
- Second, to 'nudge' scale solutions. This could be achieved, for example, by designating super trusts as recipients of

dormant pension pots or, as in Australia, giving the pensions regulator powers to require inefficient schemes to merge with larger, more efficient, schemes.

Auto-enrolment presents some real opportunities. But if we are to successfully complete the private pensions reform programme and secure the biggest prize of all – people retiring with adequate incomes – we must now tackle head on today's market inefficiencies to deliver defined contribution pensions fit for the future. That's the next big task for government of whichever stripe.

Joanne Segars is Chief Executive of the National Association of Pension Funds

INTRODUCTION

Typically on the left when we think of pensions, we think of the state old-age pension. Labour has a proud record in defending and enhancing the state pension to prevent poverty in old age. The last Labour government focused on the poorest pensioners, adding pension credit to the basic state pension to ensure that for the first time in history, pensioners were not the age group most likely to be in poverty. This was a historic Labour achievement.

Less well known was Labour's revolution in workplace pension saving. But this legacy will be of crucial importance to the next Labour government: nowhere does Ed Miliband's call for 'responsible capitalism', where a fairer, more productive economy reduces the public cost of failing markets, resonate more strongly than in the world of workplace pensions. Pension saving should deliver two things. First, a reasonable income in retirement for savers on a cost-effective basis. Second, savings should be invested in a way that develops the long-term capacity of the productive economy. The current British workplace pension system is flawed in both respects.

The next Labour government will inherit an economic mess of George Osborne's making. Money will be tight; living standards squeezed. Every penny will count. The coalition is intent on a simpler but, for many, less generous state pension. The government assumes that the new workplace

occupational pensions for all – 'auto-enrolment' – introduced by Labour will take up the slack. But the market in private pensions does not always deliver value for money. This is due to three main problems. First, the costs of pensions are hidden and can be high, allowing financial intermediaries to absorb the savings that should be creating retirement incomes. Second, there is a conflict of interest in contract-based pension schemes between delivering for savers and meeting shareholders' interests. Third, many pension schemes operate at an inadequate scale, generating extra costs and unable to support trustees who could act in the savers' interest.

There is a conflict of interest in contract-based pension schemes between delivering for savers and meeting shareholders' interests

It does not have to be this way. The workplace occupational pensions in which most Britons will save in the future can be reformed to deliver value for money. This would help the 'squeezed middle' – both directly and indirectly. Directly, because there are a set of reforms which would lower the costs of saving into a pension, ensuring people a higher income in retirement. Indirectly, because these same reforms would also lead pension providers to favour long-term, patient approaches to investment rather than a short-term casino one. As numerous commentators have observed, one of the keys to generating and sustaining higher growth in the UK is the fostering of a long-term approach amongst British businesses.

Ed Miliband has emphasised the importance of reforming markets to end consumer rip-offs. To do this, we argue that all pension providers must acquire scale, reform their governance and lower costs to savers. This will personally benefit savers in terms of lower charges but the consequences

are much broader for the economy. Michael Heseltine's report for the government on industrial policy emphasised that for a growth strategy to succeed, all departments – not just the 'economic' ones – need to act to stimulate growth. In this context, he specifically noted that UK pension funds are generally too small to cope with providing investment for infrastructure projects. Indeed, as we point out in this pamphlet, pensions in the UK are a cottage industry in need of the efficiency and expertise that scaling up has produced in other countries.

Pension credit represents a huge redistribution of resources to the poorest pensioners in our country, while the stakeholder pensions Labour introduced began the necessary reform of workplace pensions. But auto-enrolment, legislated for by the last Labour government, is potentially the most radical reform of all. The 10 million employees in the UK not saving into a workplace pension are being enrolled automatically by their employer. This cardinal fact changes the politics of pensions. An industry capable of serving these millions of new low and middle income pension savers becomes a political imperative.

This pamphlet responds to that imperative. We examine in detail the structural weaknesses and strengths of the workplace pensions market. We then move from diagnosis to prescription – explaining the proposals we have been considering under Labour's policy review. Finally, we discuss further possible steps which a sensible government, determined to deliver pensions which offer value for money and encourage economic long-termism might take in this policy area.

1. THE PRIVATE PENSIONS CHALLENGE

The last Labour government adopted three vital private pension reforms. First, stakeholder pensions which put pressure on providers to bring down the cost of workplace pensions as a means to help people build a larger pension pot. Second, auto-enrolment: companies must enrol all of their employees who are not currently contributing to a pension into one (subject to the employees right to opt-out). This started in autumn 2012. Third, Labour created the National Employment Savings Trust (NEST), a low cost, high quality not-for-profit pension provider to serve these new savers.

Labour's workplace pensions' revolution was a response to the sharp decline of traditional defined benefit schemes and their replacement by defined contribution schemes. Defined benefit pension schemes guarantee employees a fixed retirement income. Employers carry the investment risk and the longevity risk. If the pension schemes assets return too little or if pensioned employees live longer than assumed by actuaries, the employer has to meet the pension fund deficit. Defined contribution pension schemes reverse the burden of risk: the employer makes a set contribution only and the employee carries the investment and longevity risk.

One of the other distinguishing characteristics between defined benefit and defined contribution pension schemes lies in governance. All defined benefit schemes are managed

by independent trustees who have an overriding legal responsibility to prioritise member outcomes over any other interest. This is also true for some defined contribution schemes but is not necessarily the case. Many defined contribution pension schemes, even though they are put in place by the employer, are set up as individual contracts between each employee and the pension provider. The providers of such contract-based schemes do not have the legal obligation to prioritise the savers' interests over all others.

Labour's efforts to encourage everyone to save towards old age retirement have not been matched by similar responsibility on the part of all private pension providers. Many providers have been slow to make their costs and charges transparent. As a recent op-ed in the *Financial Times* put it, the pensions industry "continues to live off opaque and excessive charges". While there are many good value schemes, this lack of transparency protects some which are excessively priced and which absorb too high a share of the individual's pension savings. In contract-based schemes, fees are deducted from pension schemes by pension companies for administering the scheme and in trust-based schemes for advisers to the trustees, and in both types of scheme by fund managers who manage the underlying investments in which the pension schemes invest. The buying and selling of underlying investments also attract transaction costs. In a minority of cases, as much as half of a person's savings can be absorbed in costs and charges. The consequences are damaging for the saver caught up in such a scheme. It also brings pension saving as a whole into disrepute. This could potentially jeopardise the policy of auto-enrolment in the long run, as it relies on employees not exercising the right to opt-out.

One of the consequences of the rise of defined contribution and fall of defined benefit is that informed monitoring of

costs and charges is in decline. Where employers carry the risk, there is a greater probability of informed surveillance of costs and charges. While this may be mitigated where employers voluntarily opt to remain engaged, such engagement is less likely under auto-enrolment. This is because auto-enrolment requires smaller employers, often with more transient workforces, to enrol their employees. This is a vital step forward in ensuring wider pension coverage – but it will also inevitably lead to a situation where a greater proportion of employers are disengaged.

The costs and charges problem arises in part from the lack of informed monitoring of defined contribution workplace pensions. Pension providers often charge more themselves when they are dealing with less informed employers. They also face little pressure to maintain a cap on the costs of fund managers with whom they invest funds when neither the employers or employees have the expertise to understand the costs charged by fund managers, or even to be aware of the existence of such costs. This problem is not unique to defined contribution schemes, it can also apply to those smaller defined benefit schemes where inexpert trustees delegate all substantive financial decisions.

This problem is not unique to defined contribution schemes, it can also apply to those smaller defined benefit schemes where inexpert trustees delegate all substantive financial decisions

A lack of concern about transaction costs can lead to a bias in favour of trading models of asset management. Trading models generate returns by buying and selling shares on a short-term basis in order to benefit from price fluctuations. As Professor Kay has set out in his *Review of UK Equity Markets and Long-Term Decision-Making*, trading rather than invest-

ment models of asset management are bad for savers and bad for British companies. They are bad for British companies because it means that owners of their equity and their agents prioritise short-term financial results over the long-term sustainability of the companies in which they invest. They are bad for savers in aggregate because trading models of investment lead to a focus on trying to outperform the market index. Outperforming the index is a zero-sum game, whereby gains by some funds must be matched by losses amongst others. This means that higher transaction costs for all participants achieve no net aggregate gain in returns.

Despite a Labour campaign calling for greater transparency of costs and charges and a cap on high-charging pre-auto-enrolment pensions, the coalition government has opted to rely on voluntary codes of conduct and 'monitoring', to limited effect. NEST could also act as a market-based constraint on charges, as its own charges are comparatively low. However, there are restrictions on its activity which mean that there are many employees for which it cannot compete. Labour has called for the restrictions on NEST, discussed in Chapter 6, to be lifted, but so far the coalition has failed to act.

The fact that the initial round of auto-enrolment has been successful – opt-out rates currently sit at 5 per cent of workforces – should not lead to complacency. The early rounds of auto-enrolment have been conducted by large firms, small ones will finalise engagement in 2018. Prior to auto-enrolment, only one in three of the private-sector workforce were contributing to a pension. For those who did not participate, surveys found that distrust of the financial system was a motivating factor – and for some the most important factor. The success of auto-enrolment is fragile and must be cemented by reform. This is underlined by a recent survey

which found that a third of those not yet auto-enrolled are intending to opt-out and a third are undecided.

A future Labour government must be bold in its objectives for private pension reform. We must oblige pension providers to publish their true costs and charges in an easy to understand format. We must end other rip-offs such as penalty charges on people who move employer and a system which means that many people end up with poorer annuities than those to which they should be entitled. We must change the legal basis on which much of the pensions industry now operates. Instead of a purely contractual duty to savers, which allows pension providers to prioritise shareholder interests, we must extend fiduciary duty (which applies to defined benefit pension schemes) to all of the industry. A fiduciary duty means that pension schemes will legally have to prioritise the interests of pension savers. The government must lift the restrictions on NEST – ensuring that there is a low risk, high quality saving option for everyone. Boldness will help pension savers and those in the industry who provide good quality pensions.

The promotion of responsible capitalism within the sector through new legal duties also has important implications for the wider macro-economy. Responsible pension schemes will not use fund managers who churn investments, because this reduces the value of pensioners' savings. Pension schemes which retain share ownership on a long-term basis will necessarily have to take a longer-term view of the activities of the companies in which they hold shares. In turn, management incentivised by their shareholders to take the longer-term view is what is needed for Britain to have businesses that invest in the training, skills and the long-term product development necessary for sustained international competitiveness.

2. COSTS AND CHARGES
Clarity and simplicity are required

How pension saving works

If you save into a pension scheme, your savings are invested by the scheme into range of assets. Typically, the assets will be held in UK and foreign equities, government bonds, corporate bonds and property. These holdings are usually managed on behalf of the pension scheme by investment fund managers.

The difference between defined benefit and defined contribution schemes

Those individuals saving into defined benefit schemes can be less concerned about the effect of costs and charges. This is because they receive a guaranteed annual income in retirement. The scheme receives contributions from the employee and the employer (and tax relief) and invests them. If the scheme is not delivering returns on its investment that will meet these guarantees, then the sponsoring employer has to contribute more so that the promise is met. Defined benefit schemes also have independent trustees who should be monitoring the costs and charges set by the financial inter-

mediaries in order to ensure that they are getting the best performance possible for members of the pension scheme.

The defining characteristic of defined contribution schemes is that there is no income guarantee. The saver bears all the risk of investment. At the end of your working career, if you are saving into a defined contribution scheme you will have an accumulated sum or 'pension pot'. This pension pot will be made up not just of your contributions but also contributions from your employers and the tax relief on pensions provided by the state. These contributions are invested in assets on your behalf by the pension scheme and the fund managers whom they employ. Every year your pension pot should gradually expand as interest on your savings accumulate and are in turn re-invested. On retirement, the pot is used to buy a guaranteed annual income known as an 'annuity'.

This pension pot will be made up not just of your contributions but also contributions from your employers and the tax relief on pensions provided by the state

The impact of costs and charges on pension pots

The eventual size of the pension pot is not just a function of the extent of the contributions made and the gross returns achieved. The pension pot and the returns attract a range of costs and charges. These costs and charges can make a big difference to the eventual pension pot and thus retirement income. Their existence and levels have also been extremely opaque until now. This has permitted circumstances where in some cases too much income is being extracted by pension companies and fund managers.

Table 1 Impact on pension pot of annual fees

Fee as % assets	Reduction of pensions
0.05%	1.2%
0.15%	3.6%
0.25%	5.9%
0.50%	11.4%
0.75%	16.5%
1.00%	21.3%
1.50%	29.9%

Source: OECD Pensions Outlook 2012, June 2012

The annual management charge

The pension scheme will charge you an annual administration fee for acting on your behalf. This is known as the annual management charge (AMC). This is the headline figure around which pension companies compete when offering their services to employers. It is the figure the government and the industry quote when they say that costs and charges are coming down. But AMC's vary widely; big employers often do negotiate lower AMCs on behalf of their employees, but AMCs for employees of smaller firms can be much higher. Research for the Department for Work and Pensions (DWP) found that employees of half of small and medium-sized enterprises were paying AMCs of more than 1 per cent a year – with a small minority paying as much as 5 per cent a year.

However, it is important to appreciate that focusing only on the AMC is misleading. It is only one of a number of charges. There is as yet no common industry standard as to what it does include. The Association of British Insurers

is now seeking to remedy the latter, but their proposals are likely only to be voluntary.

As well as an AMC for a typical member, other charges may apply to savers who become 'passive' or who seek to transfer their pension pot to a new scheme. A saver becomes passive when contributions cease. This will happen when someone changes job and starts contributing to a new scheme with a new employer. Their old pension will remain dormant unless the person transfers it to the new employer's scheme. Leaving a pension dormant may attract a higher AMC – sometimes much higher. The higher AMC in these circumstances is justified as an active member discount ('AMD'), although it is in fact a penalty applied to passive members.

Pension schemes may also charge exit fees or deploy other less explicit forms of charging when a person tries to switch a pension pot from one pension provider to another.

Consultancy Fees

Where a financial adviser has set up the pension scheme on behalf of the employer, then they may have added an annual fee for doing so. In theory, these were justified on the basis of the provision of possible ongoing advice. In practice, they were fees permitted by pension schemes in order to have their schemes distributed by financial advisers. Ongoing commissions are now prohibited in the UK and advisers are required to charge up-front fees. There is a lack of regulation regarding the nature and extent of up-front fees in the context of auto-enrolment. While large firms may bear the cost of any advisers' fees, there is concern that they may be deducted from the savings of employees with small firms. The cumulative effect on the savings of the bulk of people who will switch jobs many

times during their working lives could be dramatic. The minister, the pensions regulator and the Financial Services Authority (FSA) have all expressed misgivings but have so far proved incapable of action.

The total expense ratio or 'ongoing charges'

Recognising that the AMC was not a comprehensive measure of charges, the FSA developed the total expense ratio (TER) as a more complete measure. This brings together a whole range of charges, including the AMC, legal fees, administrative fees, audit fees, marketing fees, directors' fees, regulatory fees, and 'other' expenses. It should include not just the fixed costs of the pension scheme but also the fixed costs (including the AMCs) of the underlying funds in which the pension scheme in turn invests. Pension schemes have a poor record of making these figures available. In 2012, researchers from the Royal Society of Arts' Tomorrow's Investor project contacted 23 pension providers to obtain figures for their total costs. Almost all of the respondents misleadingly insisted that the only cost faced by the saver was the headline scheme AMC.

However, it is again important to note that the TER itself is not a measure of total cost. The TER in effect measures the fixed costs regardless of trading but not the costs incurred by the fund managers as a result of trading. It does not include initial fees (eg set-up costs such as the bid-offer spread: the difference between the prices at which investments are bought and sold), performance fees, brokerage fees, market impact costs, the costs of stock-lending, taxes (eg stamp duty), interest on borrowing, and soft commissions.

The extent to which the voluntary codes being developed by the industry will lead to full declaration of the TER is

unclear. The codes may contain gaps and, as they are voluntary, individual firms may opt-out.

Transaction costs

Transaction costs are the costs incurred by fund managers as a result of trading. These costs include the costs of buying and selling assets. Total transaction costs are derived not just from the cost of each transaction but also the number of times they occur. In a year, a fund might buy or sell just a fraction of the assets held or it might turn over the entire portfolio and even do so multiple times. Investment managers sometimes argue that these should not be considered as costs to the saver since they are an unavoidable cost of delivering returns to the saver. They also say that transaction costs do not benefit the fund manager, so they have no incentive to incur them.

The argument that transaction costs are unavoidable and therefore should not be disclosed is false. It is not true that the costs are unavoidable. A fund with a focus on frequent trading will certainly incur greater transaction costs. It may be the case that it will achieve higher returns than a less active fund as a result of its strategy. This is the argument made by the proponents of active trading. Economists point out that funds with a trading strategy cannot on average out-perform the market; where an individual fund outperforms, another must under-perform. Regardless of the merits of the active trading versus passive debate, the argument made by the proponents of active investment provides no justification for hiding transaction costs.

It is also untrue to say that asset managers face no conflicts of interest with respect to incurring transaction costs. If an asset manager opts to pay a higher price to brokers in exchange for 'research' (which may or may not be used to

benefit the clients whose savings have paid for the 'research'), it will have higher costs. In its thematic review, the FSA found that most asset managers could not demonstrate that clients avoid inappropriate costs. To give another example of conflicts of interest, if a fund manager exposes the assets of the saver to risk by lending the stock owned by the saver, the saver could incur greater costs. The fund manager will have an incentive to do so if he retains any of the profits from stock-lending. Typically, asset managers have retained all or a significant proportion of the profits while passing all losses back to the client.

Currently, there is no binding template for the disclosure of costs. The Investment Managers Association (IMA) have published a voluntary code. While it is a step forward, it contains such serious flaws as to be unfit for the purpose of delivering transparency as regards the costs of pension saving. It does not require firms to declare a single figure regarding historical transaction costs. It does not require a fund which invests in other funds to declare the accumulation of transaction costs. Firms also do not have to combine transaction costs figures with the number of times a portfolio is turned over in a year. And, finally, it is a voluntary code which means that not all funds will adhere to it.

The costs of buying an annuity

Just as saving into a pension pot attracts charges, so does turning the pension pot into an annual retirement income. Annuitisation is the process whereby the accumulated savings in a defined contribution pension are exchanged for an annual sum. Typically, most savers do not shop around for an annuity, instead they purchase an annuity from the insurance company with which they save. This could be inertia in the face of complexity or it may be that many believe

that if they have trusted a pension company and saved with it all their lives then that company is most likely to reward their trust. This instinct should be the right one but often the precise opposite applies. Estimates vary, but many experts estimate that insurance companies take advantage of this loyalty to offer annuities that are often worth 20 per cent less than the annual sum which the saver would have received on the open market. The insurers argue that the provision of more information about the open market option will encourage people to turn to the open market. Only a minority of people use the open market option now and with a mass inertia-based auto-enrolment system, it is highly unlikely that engagement will improve. It seems far more likely that not-for-profit brokerage services would be better able to achieve a genuine open market outcome. NEST, for example, requires competing annuity providers to make sealed-bid offers to supply people who save with NEST.

The risks of the short-term trading model

The opacity of transaction costs is a factor which contributes to the existence of a short-term trading model for fund holding. The existing system of disclosure potentially gives the impression that the costs of investing in an active trading model with high portfolio turnover is the same as investing on a long-term holding basis. Professor Kay has highlighted that this has helped foster an investment system which operates in the interest of financial intermediaries while acting against the interests of both savers and of companies seeking equity investment. Long-term holders of assets are much more likely to adopt a stewardship approach to ownership. Paul Abberley, a previous CEO of Aviva Investors, observed: "If you are investing in a company with a long-term horizon, it very much matters to know about sustainability issues, but

if you are taking a time horizon of an average holding of six weeks, you might take the view that there may be a time bomb ticking but it is unlikely to go off in my holding period."[2]

The government has waived its responsibility for ensuring transparency. Its fetish for avoiding regulation means that it merely hopes that voluntary industry codes will meet the gap. This is likely to be a hope unfulfilled. Regardless of the goodwill and aspirations of those who work for trade associations, industry codes require the agreement not just of those who would benefit but also those who might suffer from full transparency.

There must be a simple but comprehensive declaration of the costs of saving into a pension so that savers or those acting on their behalf can see the total costs.

There are legacy pension schemes with very high annual management charges. These must be capped.

We appreciate that many employers and savers will not have the time, resources or the knowledge to use improved transparency to ensure that pension schemes and fund managers compete to keep costs low. This is why we consider that reforms of transparency are a necessary but insufficient reform. Further chapters in this pamphlet explain why these reforms should be married with reforms of scale and of governance so that pension fund trustees will use the information provided to minimise costs and maximise performance on behalf of the saver.

The government has waived its responsibility for ensuring transparency. Its fetish for avoiding regulation means that it merely hopes that voluntary industry codes will meet the gap

3. THE IMPORTANCE OF SCALE
Pensions are not a cottage industry

The UK workplace pension industry is organised on an inefficient basis. The industry is fragmented into thousands of schemes. These are often too small to operate at a level which will ensure that the members get the best possible deal in terms of lower costs for running the scheme, better investment strategies at lower cost (prioritising member outcomes rather than fund managers' profitability), better communication with members, and assistance in turning the members' pensions pots into annual retirement income.

There are currently between 1 and 2 million workers in 46,540 trust-based and hybrid defined contribution schemes in the UK. 95.9 per cent are in schemes with less than 100 people. The National Association of Pension Funds (NAPF) estimates that there are a further 134,000 non trust-based schemes organised by employers with 3 million people and another 3 million people with purely individual pensions. In addition, there are 6,850 defined benefit schemes with about a million active members, many of which will over time switch to defined contribution provision.

Modelling by the NAPF in 2011 suggests that consolidation down to a smaller number of competitors, even if that number remained as high as 40 large competitors (which the National Association of Pension Funds call "super trusts"), would deliver considerable costs savings to savers:

"Modelling undertaken for the NAPF shows that super trusts could be offered at low cost, at around 40bpts [ie 0.4 per cent], low compared to today's charges which show that the average charges in trust-based schemes are 1 per cent and that 45 per cent of contract-based schemes had charges in excess of 1 per cent. Moreover the advantages of strong governance could ensure that costs remained low and fell further as assets under management grow."

Lessons from abroad

The need to reduce fragmentation of pension provision is supported by international best practice. In a recent presentation in the UK, Richard Cooper, author of Australia's review into superannuation funds, pointed out that the United States' Thrift Savings Plan with 4 million members managed, through scale effects, to achieve annual fees of 0.025 per cent. In the UK, fragmentation and the loss of economies of scale give rise to a situation where annual management charges of 0.5 per cent are at the low end.

This example provided by Richard Cooper illustrates the more general point he has bluntly, but rightly, put to the UK industry: "Pensions are not a cottage industry." This point is also backed by research conducted in Canada by the Ontario Expert Commission on Pensions. It concluded that the cumulative advantages of scale were large. Pension schemes with scale had advantages over small schemes: lower investment fees, in-house investment expertise, private placement participation capabilities, ability to spread investment risk through diversification, reduced administrative unit costs, and enhanced availability of education, information and service. These advantages translate into material differences in retirement income. The NAPF estimate that scale could deliver a final pension to

the average saver that is nearly 30 per cent larger than that obtained by someone in a small UK scheme.

Shockingly, the coalition government has no plans to encourage scale. In Australia, recent legislation requires new duties of trustees. These include a specific duty to deliver value for money as measured by long-term net returns, and to consider annually whether the fund has sufficient scale to do so. Where the trustees fail to act they will create a legal exposure for themselves and in addition the Australian pension regulator will have the right to step in and require mergers. In the UK, perversely, the government has drawn back from steps it would otherwise like to take for the benefit of savers – and precisely because they would be disruptive for the current scale of production. For example, it is not minded to require that the consolidation of stranded small pots, left behind when people move jobs, be restricted only to schemes with scale because this would create "market distortion". In other words, this government takes the view that cottage production of pensions should be protected. This is good news for those engaged in running and advising inefficient schemes; it is not good news for the savers from whose pension savings the costs of inefficiency are deducted.

As noted in the previous chapter, Labour has campaigned for the costs and charges drawn from pension savers' pots to be transparent. While this is important in ensuring the confidence of savers, it would also play a role as a driver of consolidation. It would assist those providers who wish to compete on low costs – something which has not been practicable when the true costs are obscured due to the absence of full disclosure. The government has avoided the issue of transparency and instead threatened a cap which is long overdue. Labour would cap the worst pre-stakeholder schemes and require full transparency of the rest of the sector.

We have also campaigned for the restrictions to be lifted on the National Employment Savings Trust (NEST). This is a not-for-profit, publicly backed but independent pension provider that has been designed to operate at scale in order to deliver high quality, low cost pensions. The government has been lackadaisical about freeing up NEST to compete with the private pensions industry. One of the advantages of freeing up NEST is that by competing on quality at scale, it would force the private pensions industry to do the same. However, we need more than simply scale to remedy the problems of occupational pensions. Depending on whether a scheme is tasked to prioritise savers or meet the needs of a wider set of interests, including shareholders, the benefits of scale may be delivered to savers or they may be diluted. Ensuring savers capture the full benefit of scale means we need more schemes with independent trustees who are tasked to represent only the saver. But, equally, scale is important for ensuring that these trustees can be properly supported to deliver in the savers' interest.

4. REFORM OF GOVERNANCE
For trust, trustees are needed

There are two forms of governance in UK pensions: trust-based governance and contract-based governance. There is a major difference in the legal duties attached to those running pension schemes, depending on the type of governance to which they are subject. In a trust, the ultimate legal responsibility of those running the pension scheme is to prioritise delivery for the savers. In a contract-based scheme, the ultimate legal responsibility of those running the scheme is to deliver for shareholders.

Creating the right incentives

It is sometimes argued that the obligations placed on trustees by operation of trust law are replicated in the contract-space by the regulatory principles set out by the FSA. This is incorrect. The overriding duty of a contract-based provider is to maximise shareholder return. While it can only do this legitimately while observing the FSA principles, the FSA principles permit the contract-based provider to take into account shareholder interests. The trustee is not permitted to allow any conflict of interest at all. There is a further point of differentiation. A breach of trust creates an immediate legal liability to the members of the pension scheme. A potential breach of the FSA principles requires that the FSA agrees with a complainant that the balance of interest between

scheme saver and shareholder has been wrongly interpreted by the provider. This difference in clarity of obligation means that those responsible have different incentives under the different regimes. The effects of these incentives may manifest themselves in saver outcomes. To give one example, the active member discounts (ie deferred member penalties) discussed in Chapter Two are considered to be inconsistent with fiduciary obligations, but they are not considered inconsistent with FSA principles. Table 2 shows these differences in more detail.

Lessons from abroad

Comparison of outcomes in both the UK and abroad, suggests that savers in trust-based schemes do better than members of contract-based schemes. Research by the DWP has found that on average, savers in trust-based schemes have lower annual management charges than savers in contract-based schemes. Research by the Australian Institute of Superannuation Trustees has found that annual returns in Australia, Canada and the US are superior for trust-based (or similar) schemes as opposed to contract-based ones. Similarly, the Australian regulator has found that the investment returns of not-for-profit supertrusts outperform retail pension funds.

Responsibility and long-termism

In a normal market, the difference between fiduciary and contractual obligations should not matter. Firms that failed to prioritise customer interests would lose customers and consequently also fail their shareholders. This has the result that consumer and shareholder interests should normally be aligned. Occupational pensions are different

Table 2: Fiduciary Obligations and FSA Principles

Fiduciary Obligations	FSA Principles
Prudence:	
"The duty of a trustee is ... to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide." (Re Whiteley)	A firm must conduct its business with dueskill, care and diligence. (Principle 2) A firm must take reasonable care to ensurethe suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment. (Principle 9) A firm must arrange adequate protection for customers' assets when it is responsible for them (Principle 10)
Loyalty:	
"The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets: a fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal." (Bristol and West Building Society v Mothew)	A firm must conduct its business with integrity. (Principle 1) A firm must pay due regard to the interests of its customers and treat them fairly. (Principle 6) A firm must manage conflicts of interest fairly, both between itself and its customers and between one customer and another. (Principle 8)
Impartiality: Trustees must act "impartially between different classes of beneficiaries" (Cowan v Scargill)	

Source: Fair Pensions

for two reasons in particular. First, employees do not select their pensions. Employers buy pensions on behalf of their members. The latter may be more or less engaged, and they may be less engaged, the more transient their workforce and the less resource they have to spare for managing pensions. DWP research in 2012 found that only a minority of companies that currently arrange pensions for their employees have any understanding of the charges taken from their employees' savings. Second, it is not possible for us to experience a pension product and then ask our employer for an alternative if we find that it is inferior. By the time we experience a pension product, our working lives are over. The OECD has described the consequences of these features of the market as follows: "While improving members' financial education and enhancing disclosure can help overcome some of the blatant cases of abuse, it is highly unlikely to eliminate the massive information gap between private pension providers and individual plan members … given the complexity of investment matters and the long horizon of pension matters, expectations [that market forces will lead to efficient outcomes] may seem unwarranted."[3]

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Some point to management committees as a solution to the governance gap in contract-based schemes. Management committees are normally representatives of the employer purchasing a scheme and they may review the performance of the pension scheme. These are not a general solution, since

they rely on the existence of an employer with time, interest and capability.

If we want financial services that prioritise the savers' interest, fiduciary obligations deliver these. Fiduciary obligations will most effectively be delivered in pensions where pension schemes are managed by independent trustees.

This is not to say that all trustees are equal. Evidence collected by the pensions regulator demonstrates that trustees of small schemes can sometimes be inadequately skilled to properly represent their members' interests. In addition, there has been a tendency of trustees to construe their prudential duties narrowly, focusing only on short-term returns; a focus that some financial intermediaries have been happy to encourage. It needs to be made clearer to all trustees that prudence will generally require that they take a long-term, responsible approach. A recalibration of approach is more likely where in addition to external guidance, trustees also have better support available to them from within the pension scheme. This is why simply requiring all schemes to have trustees would on its own be an insufficient reform. This is why schemes also need to have scale, so they can provide trustees with the resources to do their job properly. It also explains why review of the regulatory regime is required. The pensions regulator may need revised powers to ensure that boards of trustees have the necessary skills, and particularly financial skills, to allow them to deliver for members.

5. THE REGULATORY SYSTEM
Ensuring pensions deliver for savers

A short assessment of the UK's regulatory system for occupational pensions can only lead to the conclusion that, as far as defined contribution schemes are concerned, it is not fit for purpose. This was essentially the finding made by the National Audit Office in its report *Regulating Defined Contribution Schemes* of 2012. There are two options for improving organisational effectiveness: either requiring enhanced co-operation between the existing bodies responsible for regulation (DWP, the pensions regulator and the FSA); or, alternatively, concentrating responsibility and power for ensuring good outcomes for savers in the hands of a single pensions' regulator. While, there is already a pensions' regulator in existence, its name belies its true status. It does not have sole responsibility for occupational pensions and it is inadequately empowered to conduct fully effective regulation.

One part of an assessment of whether the current regulatory system is fit for purpose would consist of analysing whether it is equipped to deliver on the issues we have highlighted in the preceding chapters. The reader of this pamphlet will already be aware that we see transparency of costs and charges, achieving scale, and having effective independent trustees as amongst the key characteristics of a pension system that will deliver for savers.

The pensions regulator

The UK regulatory system for pensions imposes a statutory duty on the pensions regulator to protect members' benefits in workplace schemes but in general only gives it powers of intervention to enforce its codes of practice against trustees. This means that on most issues, the pensions regulator's guidelines comprise only advice as far as contract-based schemes are concerned; advice which providers are free to ignore. The pensions regulator currently has no powers to enforce such guidance. Its information-gathering powers are also circumscribed. One of the genuinely astonishing revelations of the last year is that there is no authority collecting comprehensive information on the costs and charges taken from savers. There is only a limited survey conducted by DWP and one which is likely, given the constraints of its methodology, to fail to capture the full extent of costs and charges. Indeed, the lack of information available to the authorities means that the pensions minister Steve Webb's claim to be watching charges "like a hawk" is disingenuous.

As far as the pensions regulator's powers regarding trust-based schemes are concerned, enforcing these codes is constrained by a need to show that failing to adhere to a code means that an individual trustee is not a 'fit and proper' person. One criticism of this approach is that it could lead to requirements such as levels of financial skill being imposed on all trustees when all that may be required is that a Board of Trustees has at least one or some members with particular skills. Another criticism is that trying to use the 'fit and proper' test, designed to police the general probity of trustees, may not be a sufficient platform for pursuing wider policy goals. Other UK regulators have more direct powers. The utility regulators are empowered to enforce

licence conditions. The FSA issues binding codes to achieve its statutory objectives.

Since pensions are becoming a significant source of expenditure for all households, there is certainly a case for more regulatory powers. Utility regulatory regimes have been created in other UK sectors because services are unavoidable, substantial components of household cost and there is scope for providers in such sectors to exploit consumers. Arguably, auto-enrolment means that occupational pensions have become a utility. The cost of pensions to households rivals costs in other utility sectors. In 2010, prior to auto-enrolment, UK employers and households were already contributing £18bn a year into contract-based pensions schemes. The Pensions Policy Institute calculates that the average voluntary contribution to a private pension is 12 per cent of income. The auto-enrolment minimum is 8 per cent but people will be encouraged to save more.

Until April 2013, day-to-day regulation of contract-based provision has been shared between the pensions regulator and the FSA. The latter had responsibility for regulating the conduct of all contract-based pension providers. The FSA and the pensions regulator were supposed to co-operate to ensure beneficial outcomes for pension savers. However, as the National Audit Office tellingly pointed out, there is no shared assessment of regulatory goals. It is likely that the new Financial Conduct Authority (FCA) – which came into existence in April 2013, following the abolition of the FSA as part of a wider overhaul of the UK's financial regulation – will take a sophisticated approach to market analysis and consumer wellbeing. However, it remains that it has only a small case team focused on pensions and pensions is only a sub-set of the products which it regulates.

A market fit for savers

The FCA has announced a thematic review into the annuities market. The self-regulatory approach adopted by the industry so far has been to increase the information about shopping around to savers. The advantage of this approach for the industry is that most existing savers act as if there were a relationship of trust with their existing provider and buy an annuity from the company with which they have saved. Given this loyalty, there are fewer incentives on the company to deliver a better annuity. Incentives are unlikely to alter in the context of auto-enrolment. The new cohorts of savers brought into pension saving through a system which relies on inertia will not be more engaged participants than current savers. To meet criticisms of the current regime, the Association of British Insurers is, amongst other measures, proposing that annuity providers increase the comparative information available. In the future, they propose that their members mutually publish comparative hypothetical but not actual rates. This would seem the final baroque flourish of the flawed approach to financial regulation described by Professor Kay:

"Bad policy and bad decisions often have their origins in bad ideas. We question the exaggerated faith which market commentators place in the efficient market hypothesis, arguing that the theory represents a poor basis for either regulation or investment. Regulatory philosophy influenced by the efficient market hypothesis has placed undue reliance on information disclosure as a response to divergences in knowledge and incentives across the equity investment chain. This approach has led to the provision of large quantities of data, much of which is of little value to users."

It will be instructive to see if the FCA takes the view that the annuities market should be structured to fit the require-

ments of savers or whether it is savers who should acquire different characteristics in order to fit the market.

Pension schemes must deliver full disclosure of all costs and charges to employers and employees. While the primary responsibility should be on trustees to deliver for members, trustee accountability and performance would be enhanced where those employers and employees who can engage are able to monitor trustee performance.

With respect to scale, the Australian government has recently taken an activist stance. The Australian pensions' regulator has been given the power to require sub-scale pension schemes to merge. Trustees are also required in Australia to consider, as part of their fiduciary duty, whether they have the requisite scale to deliver for their members. It may also be the case that more stringent regulatory requirements on schemes as regards review of costs, charges and performance as well as more complete disclosure to members could add indirect pressure for schemes to achieve scale.

The Australian pensions' regulator has been given the power to require sub-scale pension schemes to merge. Trustees are also required in Australia to consider, as part of their fiduciary duty, whether they have the requisite scale to deliver for their members

With respect to requiring effective and independent trustees, there should be a review of the skills that a Board of Trustees requires to operate effectively and independently and the extent to which a regulator could underpin this. By potentially making the Board rather than the trustee the focus of requirements, this could allow a Board to maintain diversity of representation while ensuring that the Board had the necessary skill-set available to it.

We also need to consider the best way to ensure vertically-integrated pensions schemes, which combine the provision of a pension scheme and operate funds in which the scheme invests, operates in the long-term interests of savers. Trustees appointed by such schemes, could, depending on their terms of appointment, potentially face a conflict of interest between savers' interests and the interests of the in-house fund managers. Certainly, the Australian pension regulator has noted that not-for-profit Australian industry pension schemes which were not tied to specific fund providers were more likely to benefit from economies of scale. The pensions regulator has also recently raised concerns over the independence of governance of some trusts set up by insurance companies which provide the scheme and the fund providers in which it invests.

As far as defined benefit schemes are concerned, we have received few representations that the existing regulatory architecture should be amended. We do have concerns that small defined benefit schemes suffer from similar inadequacies as small defined contribution schemes. Deleterious outcomes impact less on individual savers but they do hurt the businesses which are required to meet pension deficits. There may be mechanisms that could be considered which might potentially allow smaller defined benefit schemes to benefit from economies of scale such as handing off assets to aggregators.

The UK's current regulatory system for pensions does not adequately promote low charges, scale or effective governance for pensions. Labour's policy review is examining how best it can be improved.

6. LIFTING THE RESTRICTIONS ON NEST
Making the private sector compete with a low-cost non-profit making pension provider

The last Labour government set up the National Employment Savings Trust (NEST) to ensure that a low-cost non-profit making pension provider, capable of operating at scale and answerable to an independent board of trustees, would be available to firms auto-enrolling low and medium workers into a pension.

It is widely recognised, including by its competitors, that NEST's annual management charge, set at a cost of roughly 0.5 per cent in the long run, has been one of the factors pushing the industry as a whole to reduce annual management charges. NEST also does not charge penalty fees to members that are not currently contributing.

NEST has pioneered an online system that is easy for employers and employees to use. NEST does not rely on independent financial advisers as a means for distribution, which potentially lowers the costs for employers and employees.

NEST does not use the power of inertia to extract extra profit from those requiring annuities. At retirement, an individual who has saved in NEST is presented with a decision tree which will lead them in the direction of the correct kind of annuity for their circumstances. A panel of independent annuity providers are obliged to make offers to the indi-

vidual. The latter are required to meet quality criteria set by NEST to participate. NEST can act as an honest broker because it does not provide annuities itself.

The NEST restrictions

However, the impact of NEST on the market has been constrained by restrictions imposed by government on its activity. These were added when NEST was created in order for the loan from the Treasury, which has met NEST's set up costs, to be allowed under the EU's 'state aid' rules. The restrictions on NEST comprise of a ban on 'transfers-in' from other pension schemes and a cap on the amount that can be paid in by any individual into a NEST account in the course of a year. The latter is intended to make it unattractive for higher-earners to save with NEST. The ban on transfers-in prevents pension pots accumulated with past schemes being transferred to NEST. The motivation for imposing these two restrictions was to ensure, in line with state aid rules, that NEST did not use its government subsidy to go beyond its public service obligation and use the loan to drive out existing pension providers.

We have already published our full legal advice on state aid and the NEST restrictions. Our view, in line with EU state aid law jurisprudence, is that these two restrictions are now no longer needed in order for NEST's loan to be compatible with the EU's state aid rules. As part of this legal analysis, we pointed out that these restrictions interfere with NEST's public service obligation to provide low cost saving to low and medium earners. And that this degree of interference is unnecessary, as there is substantial scope for private competitors to react to an unfettered NEST and maintain a competitive market.

The cap on the amount contributed is unnecessary to ensure that NEST remains focussed on low and medium

earners. The legally binding public service requirement on NEST to serve all means that NEST already has a positive duty to serve low and medium earners.

The cap damages NEST's ability to serve its target market. This is primarily because most employers want a single pension provider to serve a combined workforce of low, medium and higher earners. The damage arises in two respects:

i. Many businesses will not consider NEST and may enrol their lower paid workers in schemes that do not meet the price and objective quality standards that would be most appropriate for them; and
ii. Pensions is an industry subject to economies of scale. By being excluded from large segments of the market, the cost of participation in NEST will be driven up for those employees who do belong to it.

The arbitrary nature of the monetary limit on contributions also undermines the aims of NEST in other ways. On the one hand, it does not take into account the age at which someone begins a pension. If the age of the individual is say 45 and they are starting a pension, then they need to be paying in a much higher percentage of their salary in order to achieve a reasonable income in retirement compared with a 25-year-old. On the other, it potentially also excludes any employers who want to make a higher contribution rate for their employees than the auto-enrolment minimum.

The cap is not necessary to ensure that private pensions' provision is preserved. First, NEST is unlikely ever to be of interest to firms with high proportions of higher earners. Such employers will want more bespoke and differentiated products than those which NEST provides, such as the inclusion of SIPPS (pensions where the individual herself

manages the portfolio of assets in which her pension scheme is invested). Second, NEST must serve loss-making savers which its private sector rivals can avoid altogether. The latter can and do on occasion offer lower annual management charges than NEST can match, as they can concentrate solely on profit-making customers. Third, the fragmented nature of the pensions market means that there is significant scope for private sector operators to achieve economies of scale through internal reorganisation and through market consolidation. If NEST were to begin to acquire scale, other operators can match this. It is worth noting that NEST is still a fraction of the size of its largest private sector rivals.

The ban on transfers-in prevents employers from selecting NEST to take over accumulated savings, even where the terms available from NEST are better than those the employees can currently obtain. It means that where an employer decides to opt for NEST, it would potentially expose its employees to penalty payments with respect to accumulated pensions savings.

Allowing transfers-in to NEST would encourage private pension providers to maintain and expand their customer base by improving the quality of their service with respect to accumulated savings. It may be that some individual providers would be unable or unwilling to do so, and by that failure would become less competitive. But as discussed above, there is extensive scope for market consolidation in this sector and for private pension providers to improve their services.

NEST must serve loss-making savers which its private sector rivals can avoid altogether

Labour has been campaigning for the restrictions on NEST to be lifted. At first, the pensions minister claimed that EU state aid

law meant this was impossible. Since we published our legal advice, the government's position seems to have shifted. The government should now lift the contribution cap and the transfer ban. An unfettered NEST would create greater pressure for lower costs and charges and provide an example in the market of the benefits of scale and of good governance.

CONCLUSION
Pensions people can trust

A revolution, instigated by the previous Labour government, is underway in workplace pensions. All employees are gradually being auto-enrolled into workplace pensions.[4] But the pension schemes into which they save may not meet the ideal of providing low cost, large scale and governance solely in the interests of the saver. Poor pension provision is equivalent to an extra tax on these new pension savers, drawn primarily from low to medium earners. Unlike a tax, they will have the ability to opt-out if schemes do not prioritise delivering for them. If that happens, we will lose the benefits of the revolution and revert to the *ancien regime* of coverage for a minority. The current government has no apparent vision for workplace pensions, so the danger is a very real one. This is why we need a Labour government to implement our vision for pensions people can trust.

High levels of pension saving in schemes with a focus on the savers' interest would potentially create a virtuous circle. Such schemes would have the capital and the incentives to be long-term investors in British industry and infrastructure. The workplace pension system could be a paradigm for the kind of economy for which Ed Miliband has called: one where looking after the interests of employees means economic success for us all.

Footnotes

1. Assumes median earning man who remains opted into saving from age 30, contributes an extra 1% of band earnings and receives an extra 1% contribution from their employer, is in a scheme with low charges, works for an extra year beyond state pension age, and who shops around for a better priced annuity. This could take the individual's pension from £2,200 a year to £7,710 a year.

2. Guardian, 4 Feb 2011 "Aviva chief attacks City for failure on sustainability".

3. Stewart, F. and J. Yermo (2008), "Pension Fund Governance: Challenges and Potential Solutions", OECD Working Papers on Insurance and Private Pensions, No. 18, OECD publishing.

4. The coalition government are excluding over a million lower paid workers from automatic participation, 78 per cent of whom are women. This is a compromise attempt to meet the Conservative peer Lord Beecroft's demand that the impact of auto-enrolment on smaller firms be limited.

Glossary

Annual management charge (AMC): This is the fee that providers charge to manage a pension fund and is the headline figure around which pension companies compete when offering their services to employers.

Auto-enrolment: This started in autumn 2012 and was legislated for by the last Labour government. Employees in the UK not saving into an approved workplace pension must be enrolled automatically by their employer who must also make a contribution. Employees have the the right to opt-out.

Defined benefit pension schemes: These schemes guarantee employees a fixed retirement income related to their years of service. Employers carry the risk: if the pension schemes assets return too little or if pensioned employees live longer than assumed by actuaries, the employer has to meet the pension fund deficit. All defined benefit schemes are managed by independent trustees who have an overriding legal responsibility to prioritise member outcomes over any other interest

Defined contribution pension schemes: These schemes offer no income guarantee before retirement begins and the saver bears all the risk of investment until this point. A saver accumulates a 'pension pot' over their career from their own contributions as well as employer contributions and tax relief. These contributions are invested in assets by the pension scheme and the fund managers whom they employ. On retirement, the pot is used to buy a guaranteed annual income known as an 'annuity'. Many defined contribution pension schemes are set up as individual contracts

between each employee and the pension provider. The providers of such contract-based schemes do not have the legal obligation to prioritise the savers' interests over all others.

Fiduciary duty: Legally establishes a relationship of trust and means that pension schemes will have to prioritise the interests of pension savers by law.

Financial Conduct Authority: Came into existence in April 2013, following the abolition of the Financial Services Authority as part of a wider overhaul of the UK's system of financial regulation.

National Employment Savings Trust (NEST): A low-cost, non-profit pension provider set up by the last Labour government. It is answerable to an independent board of trustees and available to firms auto-enrolling low and medium earners into a pension.

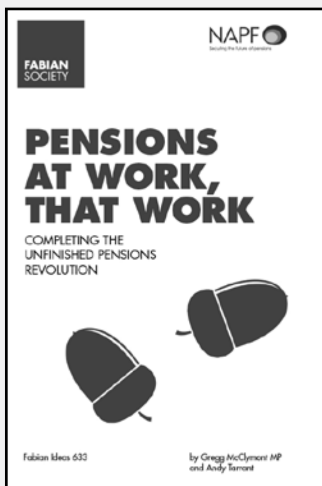
Pensions regulator: The quango which regulates the UK's work-based pensions industry. The UK regulatory system for pensions imposes a statutory duty on the pensions regulator to protect members' benefits in workplace schemes but in general only gives it powers of intervention to enforce its codes of practice against trustees.

Self-Invested Personal Pension (SIPPS): An investment vehicle for higher-paid workers which allows an individual to manage the portfolio of assets in which their pension scheme is invested.

Stakeholder pensions: Introduced by the Labour government in 2001 to put pressure on providers to bring down the cost of workplace pensions and encourage retirement saving among those on low and medium incomes.

Total expense ratio (TER): This brings together a whole range of charges, including the annual management charge, legal fees, administrative fees, audit fees, marketing fees, directors' fees, regulatory fees, and 'other' expenses. It should include not just the fixed costs of the pension scheme but also the fixed costs of the underlying funds in which the pension scheme invests. However, it is important to note that the TER itself is not a measure of total cost. The TER in effect measures the fixed costs regardless of trading but not the costs incurred by the fund managers as a result of trading.

Trust-based governance and contract-based governance: There is a major difference in the legal duties which attach to those running pension schemes depending on the type of governance to which they are subject. In a trust, the ultimate legal responsibility of those running the pension scheme is to prioritise delivery for the members. In a contract-based scheme, the ultimate legal responsibility of those running the scheme is to deliver for shareholders



Discussion Guide: Pensions at Work, that Work

How to use this Discussion Guide

The guide can be used in various ways by Fabian Local Societies, local political party meetings and trade union branches, student societies, NGOs and other groups.

- You might hold a discussion among local members or invite a guest speaker – for example, an MP, academic or local practitioner to lead a group discussion.

- Some different key themes are suggested. You might choose to spend 15 – 20 minutes on each area, or decide to focus the whole discussion on one of the issues for a more detailed discussion.

1. The authors write that “nowhere does Ed Miliband’s call for ‘responsible capitalism’ resonate more strongly than in the world of workplace pensions.” Do pensions show how Labour can take the idea of responsible capitalism out of the seminar room and onto the doorstep? What other policy areas might be in the same category?

2. Tackling pensioner poverty was hugely important to the last Labour government – the pamphlet calls it “a historic Labour achievement”. But a big insight of Labour’s ongoing rethink in opposition is that the party was ‘too hands off with the market and too hands on with the state’: Labour didn’t think it could do much about the market so tried to correct its failings via state-led redistribution, for example through pension credit. Some have suggested this was not only expensive but disempowering, as people still need the state to top up their incomes. Does reforming private pensions offer an opportunity to ‘predistribute’ rather than redistribute?

3. Do you agree with the authors that the Labour government’s measures – stakeholder pensions, auto-enrolment and establishing the National Employment Savings Trust – constituted a “workplace pensions revolution”? How can these measures provide a platform for the next Labour government’s private pensions policy?

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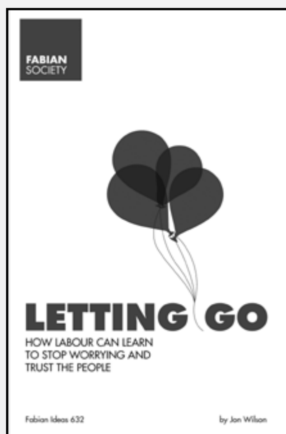

Letting Go

How Labour can learn to stop worrying and trust the people

If you get people in a room together, if people have the freedom to meet, talk and argue, they'll make better decisions about the things which affect their lives than anyone else.

In 'Letting Go: How Labour can learn to stop worrying and trust the people' Jon Wilson argues that Labour needs to become a movement rooted in people's experience, not be the party of the central manager.

Above all, it needs to trust people again. The politician's vocation should be to create institutions where those conversations happen, not determine what they decide.

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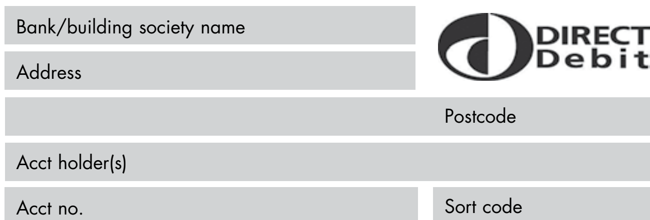
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Pensions at Work, that Work

Completing the unfinished pensions revolution

Typically when the left thinks of pensions, it thinks of the state old-age pension. The last Labour government focused on the poorest pensioners, adding pension credit to the basic state pension to ensure that for the first time in history, pensioners were not the age group most likely to be in poverty.

Less well known was the revolution in workplace pension saving that has taken place over the last decade. But this legacy will be of crucial importance to the next Labour government: nowhere does the idea of building a more 'responsible capitalism' resonate more strongly than in the world of workplace pensions. Pension saving should deliver two things. First, a reasonable income in retirement for savers on a cost-effective basis. Second, savings should be invested in a way that develops the long-term capacity of the productive economy. The current British workplace pension system is flawed in both respects.

This pamphlet sets out a series of reforms to ensure that the occupational pensions in which most Britons save provide value for money. These reforms would not only lower the costs of saving, ensuring people a higher income in retirement, but also lead pension providers to favour the long-term, patient approaches to investment that are necessary to sustaining higher growth in the UK.

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Fabian Ideas 633
Subject: Next State
ISBN 978-0-7163-0633-7
£9.95