Buck Consultants' response to DWP consultation on Personal Accounts

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Overview

We agree with the conclusion of the Pensions Commission and the findings of the White Paper that the current lack of overall pensions savings in the UK presents a serious problem. It is a problem for the nation as a whole because of the potential burden on the state to provide retirement income for its citizens who will not be in a position to provide for themselves, and especially a burden for those who are making the least provision.

It is certainly true, as supported by the research underpinning the proposals for Personal Accounts, that present coverage of retirement benefit arrangements is uneven. There is a group of people who, mostly with the assistance of their employer, are engaged in private (i.e. non-state) provision and are well provided-for. The system responsible for this fortunate outcome is well-established and generally efficient, albeit that it has been suffering immense and increasing stress over the past decade as a result of a number of factors, both economic and legislative-driven, which have severely reduced the level of coverage, both in terms of numbers of people covered, and the average benefits being provided.

However, the overall success of this system, and the investment by the state in a rigorous regulatory and protection system, demonstrates its importance. Occupational schemes alone were actively involved in providing benefit accrual for some 4.7 million people, as well as paying the pensions of 5.3 million more (2005 figures from the Government Actuary's Department). In addition, there are a large number of personal pension and stakeholder contracts in force for employees. It is vital to the UK's future prosperity therefore that this system continues to flourish, for the benefit of those who are fortunate enough to be its beneficiaries. As we have already mentioned, this system is under stress at the moment, and as a result many employers are feeling compelled for legitimate business reasons to reduce their commitment.

It cannot be overemphasised therefore how important it is that this system is supported by government policies, rather then being undermined by them. The system is largely 'fit for purpose' and so the creation of a separate system to address the savings deficiencies of those who are unable to benefit from it should remain entirely separate and complement it, rather than compete. We are pleased to see statements from the government indicating acceptance of this principle, and we welcome the provisions that have been included in the White Paper to support it.

However, given the present fragility of the occupational system, it is important that employers' continued practical support is not taken for granted. We believe that a number of elements of the current proposals have the potential to undermine the current occupational system, and that consequently there should be a process applied to check each element of the final detail to ensure that they do not.

Personal Accounts – the principle

We are broadly supportive of the concept of the National Pension Savings Scheme (NPSS) as proposed by the Pensions Commission. We believe that it is essential that the 'savings gap' identified by its research be filled, and given the long timescales involved in pensions saving, this process should commence as soon as possible. We do not have a strong view as to whether this gap in saving should be filled by the state or by the private sector (there are arguments in support of either approach, which we will not repeat here) – the important thing is that it is filled, by a system that is as effective as possible, which gets as much of the savings as possible to the member, and which does not have any negative impact upon other arrangements that are already working effectively.

Consequently, we believe the Commission's idea to create a system whereby every individual is encouraged to make some contribution to their own retirement income provision is sound in principle. Now that this has developed into the proposed system of Personal Accounts, careful thought needs to be given to the design of these, to ensure that the original concept is not corrupted, even inadvertently.

Apart from this, we do have some observations on design aspects arising from the original NPSS concept that has been carried across to Personal Accounts, which cause us concern.

NPSS design concerns

The lack of investment advice

We are concerned about the lack of advice that will ordinarily be available to members in respect of the monies held in their Personal Accounts. There have been a considerable number of surveys showing the very poor level of understanding of investment principles by individuals, and this is demonstrated daily by the investment decisions actually taken by individuals, whether in occupational defined contribution schemes or personal pension or stakeholder accounts.

We applaud the recent initiative to improve financial knowledge (and thereby hopefully ability) by the creation of the new taskforce to improve the financial capability of the most vulnerable, and to create a national approach to generic financial advice. In this area, any improvement is to be welcomed.

However, any such initiative will inevitably be of limited effect, and will probably take time to produce an effect – time which many of the proposed target group for Personal Accounts do not have. We stress that this is not a criticism of the initiative – only recognition of the difficulty (if not impossibility) of the task of significantly raising the financial capabilities of many in today's workforce.

Consequently, we have to look in practice at other possible solutions. We believe that these must revolve around the provision of expert assistance. This could be in the form of limited (to keep costs down) specific financial advice and/or careful selection of the investment 'default fund', which experience tells us will be the fund selected by the majority of account holders.

In the case of financial advice, this suggests that the administration costs for Personal Accounts have to be higher than that currently envisaged. Although we recognise and concur with the principle that these Accounts should be as simple and cheap as possible, some allowance for advice could, we believe, be a sound investment of an Account holder's monies.

The issue of the default fund is also a difficult one. Since so many Account holders can be expected to use it, believing it to be 'safe', it has by definition to carry a low risk – with the usual implications for returns. It is very common today for default funds to be of the 'lifestyling' variety, whereby the manager invests the monies in higher risk entities in the earlier years, hoping to obtain a better return over the longer investment period, where any value fluctuations can hopefully be levelled-out, and moving in a structured way more towards lower-risk investments as retirement approaches.

However, in view of the erratic employment situations of many of the likely Account holders, and in any case the probable breaking down in future of the historical employment/retirement relationship, exacerbated by the introduction of measures to combat age discrimination, we would urge extreme caution over selecting a lifestyling fund for the default fund for Personal Accounts.

One possible candidate that should be considered for default funds is a version of the 'with profits' type. Past versions of these investment types have received bad press, but the basic concept of pooled investments, expertly managed to achieve a smoothing of returns, is sound and, we believe, lends itself well to the Personal Accounts system, where most members will be needing steady growth and security, with the flexibility to take their benefits at times that may not have been envisaged when they effected their Personal Account. If this is done through a single investment manager, the absence of competition should avoid the jostling for headline figures that occurred in the latter years of the old with profits funds' heyday and which arguably led to the system's collapse and resulting loss of confidence. We recommend that thought is given as to whether such an investment vehicle could be produced to meet the needs of a default fund.

There is also a more general point that should be borne in mind whatever the investment funds offered. Account holders will initially place a great deal of trust in the Accounts, if only because they are 'government-recommended'. Their expectations will be high, often unrealistically so. To avoid future disappointment and resulting problems, Account holders must understand the limitations of the Accounts. This also suggests that financial advice on an individual basis would be desirable to manage expectations effectively.

The need to purchase annuities

This is a perennial problem that afflicts the members of all defined contribution arrangements. The cost of buying annuities in the open market is going to present particular problems in the case of Personal Accounts because:

- the size of average funds will be such that the typical annuity purchased will be very small

- there will be a perception problem with many members, leading to disaffection with Personal Accounts; if the effects of annuity purchase are recognised by the member early on, then many will opt-out, believing it not to be an appropriate home for their savings.

We therefore recommend that the old principle of trivial commutation that existed before 6 April 2006 be reinstated for Personal Accounts, whereby a fund below a given level can be fully commuted. The level should be set broadly by reference to the amount of the annuity that the fund could purchase and we recommend that the minimum annuity that anyone should be compelled to buy should be £500 p.a. in today's terms.

Issues with proposed Personal Accounts

Compulsion

There are widely-differing views on compulsion held by pensions experts, employers and others, and that position is also reflected in the views held within Buck Consultants. However, overall we are content to accept the Pensions Commission's view on this – but subject to one very important caveat. The relationship between Personal Accounts and state pension benefits must be such that **no one must end up in the position where they do not get the full value of the contributions put into a Personal Account by or for them.**

There has been a lot of comment about the exact effects of this interrelationship in particular cases, with the government and its critics arguing over minutiae; however, the mere fact that such arguments are possible at all demonstrates all too clearly that there is a problem with the present means-testing system that needs to be addressed. If Personal Accounts are to be successful and not result in finally killing-off any residual public goodwill in pension provision, it must be crystal clear to all participants that they are getting what they regard as their full value from the contributions that they and their employers are being forced to make. **This principle must be sacrosanct and non-negotiable.**

The opting-out system

The period between the occasions when individuals are required to repeat their decision to opt-out of Personal Accounts or be enrolled should not be so short as to annoy them when they believe they have only recently made their decision the last time; it should also not cause undue difficulties (practical or financial) for employers, who will have to administer the system. On the other hand, we respect the need to maintain pressure on those voluntarily not making any provision for their retirement, and giving them regular opportunities to reflect changes in their situation.

Consequently, we believe that the proposed three year cycle is the most frequent that should be introduced, and that it could be lengthened to a four or even five year cycle without causing significant detriment to the interests of affected individuals, but would assist hard-pressed employers.

The actual process which employers will have to administer, and the regulatory requirements that they will have to satisfy must not be too burdensome on them. It must be remembered that

a large number of employers whose employees will fall within the Personal Accounts system will be small and will not have the sophisticated HR systems that larger employers possess. One of the common faults of past regulatory systems in the pensions arena has been their onerous and unduly bureaucratic and prescriptive forms, which seem all too often to be designed with only the large employer in mind. The recent move in a number of regulatory areas to adopt underlying principles of *proportionality* should be copied here.

The relationship with existing workplace arrangements

As mentioned in the overview above, it is vital that Personal Accounts do not undermine existing workplace provision; as simple, low-cost, low-benefit arrangements targeted to fill a particular gap they will not benefit from the sophistication that applies to employer-sponsored arrangements. As previously mentioned, the latter are particularly important for their target market, and Personal Accounts would provide a very third-rate alternative for that market.

The test that employer-sponsored arrangements will have to pass in order for the sponsoring employer to be exempt from providing Personal Accounts must be straightforward and clear, and fully reflect the value that the workplace arrangement is providing.

We are especially concerned about a particular proposal to move from the original concept as proposed by the Pensions Commission, which we believe would undermine workplace provision – that of the maximum level of contributions that it is proposed to permit into Personal Accounts. Given our earlier comments on maintaining the proper focus of these arrangements, we see no justification for allowing contributions above the annual £3,000 level proposed by the Pensions Commission; in particular we regard the proposal to allow the payment of a contribution of up to £10,000 in the first year to be a result of muddled thinking about the purpose and target market for Personal Accounts. Although many in the target market have many years of neglect to catch up on, they will not be in a financial position to pay such a large contribution in one year; the only people who would are those with higher disposable incomes, for whom Personal Accounts are not designed, and would not be appropriate.

Allowing such high levels of contribution would send completely the wrong message and contribute to the undermining of workplace arrangements.

Waiting periods

The vast majority of Buck Consultants' existing clients who offer membership of a group personal pension (GPP) operate a three or six month waiting period. This minimises the administrative burden and costs for employers associated with new employees who only stay with them for a short period of time. In order to minimise the cost for employers in making changes to these existing pension arrangements and in funding generous pension provision for a short period of time, we support the allowance of a waiting period of up to six months to qualify for the exemption.

If a waiting period exemption was not permitted, those employees who join a GPP but leave the employer after a few weeks/months, would only accumulate a very small fund – around £300 for an average person earning £23,000, with contributions totalling 8% for two months. We

generally find that employees do not contribute to these plans again once they leave their employer. They are also unlikely to transfer them to other pension arrangements. This type of transaction would normally require financial advice, which is not easily accessible for many individuals and is not likely to be cost-efficient for them. Also, the potential transfer value is likely to be lower than the minimum amount that might be accepted by pension providers. This could result in many very small pension funds being left behind in arrangements set up by previous employers.

We believe that a six month waiting period exemption strikes an appropriate balance here, whatever the type of arrangement. Consequently, we are not convinced that tying such a waiting period to the provision of benefits more generous than the Personal Account's minimum will significantly affect employers' behaviour.

Statutory objective for the new Delivery Authority and Board – a fundamental requirement

The issue of ensuring that all aspects of the Personal Account systems are tested to ensure they do not have an adverse effect on employers or the schemes they sponsor is so important that it should be enshrined in statute as a principle to be followed by both the proposed Delivery Authority and the permanent Board, in the same way that the Pensions Regulator is required to follow its own set of principles.

Other statutory principles should require these organisations to maintain the focus of the design and delivery of Personal Accounts to the designated group, and to ensure that the end products always adhere to the principles of simplicity and clarity.

The self-employed

Finally, we would like to make one general observation for consideration, although it does not fall directly within the interest areas of Buck Consultants or of most of its clients.

Given the principles behind the Personal Accounts proposals, and the effects on the future economy and social fabric of the country if there continues to be a substantial proportion of the population not providing for their retirement, we find the proposals only to *encourage* the self-employed to participate to be very weak. It seems unlikely that this group, who have broadly shown little inclination to engage with pension provision in the past, will change their attitude in the future.

If those in employment are effectively to be compelled to do so, there will be considerable resentment building up against the self-employed who face no such pressure and who are heading towards a retirement at taxpayers' expense. Given in particular the growing numbers of self-employed contractors and franchisees who were formerly employees, and who on a move out of employment would not be subject to the proposed new soft compulsion regime, this could undermine attempts to improve the national retirement savings rate.

Summary of recommendations

- Review appropriate designs for the default investment fund.
- Restrict obligation to purchase annuities to a sensible and practical level.
- Ensure that no one can lose value from their contributions through the operation of the state scheme.
- Consider the creation of a new 'designed for purpose' default fund for Personal Account monies.
- Impose statutory duties upon the Delivery Authority and Board to:
  - have regard to the effects of their actions and requirements upon employers and their employees' pension arrangements
  - ensure that the design of Personal Accounts remains focused on the original target market identified by the Pensions Commission
  - ensure that the end products always adhere to the principles of simplicity and clarity.

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