Dear Frank,

**Supplementary information from NEST Corporation**

Thank you for inviting NEST to give evidence to the Select Committee on pensions automatic enrolment on 23 January. I welcomed the opportunity to answer questions about NEST’s role in delivering auto enrolment and the challenges and opportunities that lie ahead. Auto enrolment is set to have a significant positive impact on the pension outcomes of millions of people in the UK and we are keen to work with Government and the industry to build on the initial success of the programme.

I am writing in response to your letters dated 18 February in which you asked for supplementary information on a number of points. I have set out our answers to your questions below. Please do let me know if you would like any further information about any of these areas.

**How do you measure the costs which are passed on to your customers? How are these communicated?**

NEST has three different customer groups: members, employers and intermediaries (organisations such as accountants or financial advisors who support employers to sign up to a pension scheme). NEST was established to facilitate the delivery of auto enrolment and has a Public Service Obligation (PSO) to accept any employer that wishes to use the scheme. As such we do not charge or pass on any costs to employer or intermediary customers.

NEST member charges are made up of two components: an annual management charge (AMC) of 0.3 per cent on the total value of a member’s fund each year and a contribution charge of 1.8 per cent on each new contribution into a member’s retirement pot. For many members our charges
work out as broadly equivalent to 0.5 per cent AMC over their saving lifetime. This is a good benchmark for the low charges currently enjoyed by members of large workplace pension schemes. Some members will experience a slightly lower rate, particularly if they have contribution breaks. Some savers, if they are enrolled later in life, may experience a higher rate.

We provide details of the contribution and annual management charges members have paid each year in the Annual Benefit Statement (ABS). We also maintain information about our charges across a range of other communication materials, including our website and our member welcome packs.

**What data is used by your Board to measure your costs and returns against those of your competitors?**

We have an overarching investment objective for NEST’s default funds to target investment returns in excess of inflation after all charges over the long term. We have three investment phases within the default strategy: foundation, growth and consolidation. These reflect a different approach to risk and return for our members at different ages. Most members will spend most of their time saving with NEST within the growth phase. Our objective for the growth phase is to deliver returns of CPI + 3 per cent after all charges over the long term. Our funds in the growth phase have been outperforming this objective in most years since we started investing in August 2011. Our nominal, annual returns before charges are shown in the table below.

<table>
<thead>
<tr>
<th>Fund</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual gross returns</td>
<td>8.8</td>
<td>12.6</td>
<td>11.7</td>
<td>3.8</td>
<td>21.0</td>
<td>9.8</td>
<td>-4.0</td>
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<tr>
<td>for 2040 Retirement</td>
<td></td>
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<tr>
<td>Date Fund</td>
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</tbody>
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We publish information on our fund performance in our Quarterly Investment Reports. We also share our fund performance data and daily unit prices on comparison sites MorningStar and TrustNet, and in regular reports including Corporate Adviser’s ‘Master Trust Default Report’.

Whilst we informally monitor the performance of other pension schemes, our focus is on delivering the right risk-adjusted returns for the particular demographic of our membership, recognising their preferences and behavioural economic drivers. For example, on the basis of research into the investment preferences of our members, we have opted to expose younger NEST members (those in the foundation phase) to slightly less risk in order to help develop confidence in saving for the longer term. Our performance to date has been comparable to other schemes in terms of absolute returns, and better than most in terms of risk-adjusted returns. Put another way - we are achieving good investment returns without exposing our members to excessive volatility, something our research shows they wish to avoid.

**What lessons can be learned from Australia, or elsewhere about the experience of more mature auto enrolment systems? What evidence is there about how people behave as they**
approach retirement, and how engaged are they with finding the most appropriate decumulation products?

As we have submitted to the Committee in previous evidence, we believe there is a disconnect between the behavioural forces at play during the accumulation and decumulation phases of the retirement journey in the UK. During accumulation, members are automatically enrolled in a pension scheme without making an active choice to save. However, the freedom and choice reforms mean that when members reach retirement they have to make a set of very active and involved decisions about how to access their savings, which due to the behavioural barriers and information asymmetries associated with pensions, they may find difficult to take.

Savers in the Australian superannuation system are subject to a very similar tension. During accumulation savers generally save in the default fund of a superannuation scheme designed for the industry they work in. But when they want to access their funds they may have to decide on factors such as the amount of money they will need each year, likely investment performance over a 20-year investment horizon, and how long they may live for. The 2014 Murray inquiry into the Australian financial system found significant evidence of member detriment as a result of these complex decisions. More than half of savers are ‘worried’ or ‘extremely worried’ about the prospect of outliving their savings and consequently live less comfortably than they would otherwise reasonably have to do.¹

As the Committee heard in the 2018 pension freedoms inquiry this is consistent with the emerging experience in the UK. We believe that a key lesson from Australia is that on its own, advice and guidance is not enough to support pension savers in making retirement decisions.

NEST continues to believe that guided retirement pathways, in which pension schemes both guide members into a suitable investment approach for retirement and pay out a sustainable income for life, are likely to best meet the needs of large parts of our membership over time. We continue to ask to be enabled through legislation to deliver flexible access drawdown to our members as a component of delivering this type of pathway. We thank the Committee for its support over this in the report following the pension freedoms inquiry.

Indeed, we believe that increasingly this type of retirement solution will be seen as a prerequisite of any high-quality scheme. We are pleased that in its latest consultation the FCA is pushing for schemes within its remit to offer guided investment pathways within drawdown - which is an acknowledgement that consumers are often failing to take active choices in their best interests in retirement. NEST would argue that the same consumer protections should be applied to setting a sustainable withdrawal rate in drawdown - as the Australian evidence suggests.

There are further lessons for the UK from Australia’s Productivity Commission and Royal Commission into banking misconduct. The findings of the Commission demonstrate the hazard of ‘set-and-forget’ mechanisms where they are not in the interests of the consumer: thousands of consumers have unwittingly overpaid commission or been enrolled into products that are unsuitable to their needs. But it has also shown how well-run schemes operating at scale with a small choice of default funds can deliver better returns to members.

Governance is critical here. UK schemes - many of which already operate at lower cost than their Australian counterparts - have a real opportunity now to take these lessons on board and deliver

best value to members through a focus on scale, strong governance and well-designed defaults tailored to the membership. It is important that Government and regulators look closely at this evidence now and take steps to provide the right structural consumer protections in retirement - across occupational and retail schemes, and within trust and IGC-led contexts - rather than waiting for evidence of consumer hazard to emerge.

The Pension and Lifetime Saving Association’s new Master Trust Committee is currently looking into what conclusions can be drawn by the UK from the findings of the Australian Royal Commission. PLSA would be happy to share this work with the Committee later in the year.

**How will you be supporting employers to move beyond simple compliance with auto enrolment, to considering wider issues such as risk and return?**

NEST works closely with the advisor community to ensure our total proposition and performance is fully understood. This increases confidence amongst their employer clients that NEST is a good value scheme. We supply all our 750,000+ employers with communication materials that they can download, customise and use in their online and offline spaces to provide more information about NEST pensions to their employees. We also communicate legislative changes to employers, such as increases to statutory contributions, informing them of the direct and indirect impact and guiding them on associated compliance requirements.

**What are the largest risks to preventing the next stage of auto enrolment being a success?**

Automatic enrolment was built on the foundations of a powerful political consensus driven on the back of the Pensions Commission reports. Its success today reflects the strength of that consensus: despite changes of Government and political direction, the programme has been delivered and planned increases to contributions are happening, if on a slower timetable than that originally envisaged.

There is clearly a risk that in a period of economic uncertainty and instability, automatic enrolment is reformed in ways that are not consistent with the original aims for the programme: to provide better retirement incomes for mass market savers, address the ‘savings gap’ and ensure that there is a meaningful second pillar in place as DB continues to decline.

It is important now that the industry, Government, employers and consumer groups come together to plan for the next phase of auto enrolment in a coherent way, considering where contribution levels need to ‘land’ to best meet the needs of savers, and how to bring more people into saving where they would benefit from it. NEST believes the reforms proposed in the 2017 Auto Enrolment Review to remove the lower earnings limit and lower eligibility for automatic enrolment from 21 to 18 would be a positive start in this respect. We also believe that as contributions rise, we should consider how building elements of liquidity into pension saving could help improve savers’ financial resilience whilst better enabling them to keep saving for the longer term - which is the thinking behind the sidecar savings trials.

**NEST Insight sidecar savings**

‘Sidecar’ savings is a research trial run by NEST Insight, our in-house research unit. Employers voluntarily sign up to participate in the trial and offer their workers the opportunity to opt-in to an additional payroll deduction, over and above the auto enrolment minimums, which then goes to a liquid ‘emergency savings’ account. The additional contributions begin to flow into the
saver’s pension account once the emergency balance reaches a threshold - so the model doubles as both a mechanism to give people greater emergency liquidity, and a pre-commitment device to increase pension contributions in the future once greater short-term resilience is achieved.

NEST Insight’s role is in the research design and management, working with partners at Harvard University and the Single Financial Guidance Body. Though the initial employer adopters are employers currently using NEST, we have also spoken to non-NEST employers about participating. It is very much a research project, not a ‘product trial’. The results will be made widely available, and we are excited to see that some other providers are already exploring offering some form of sidecar savings mechanism.

You asked what consideration is being given to how the sidecar will work in practice. Testing whether, and how, such a model might work at all is an important goal of the project. We expect to learn things about demand among workers, approaches to encouraging take-up, behaviours in terms of how and why the money is accessed, how fast it builds and whether and how fast new money begins to flow to pension saving. To learn these things, the trial has developed a relatively simple core model: employees are asked to sign up through their employer, and where they do so, their contributions (taken post-tax) will be paid across to the payroll integration and banking partners appointed under the project (Salary Finance and Yorkshire Building Society). NEST Insight will collect data across the various partners and supplement it with a three-wave survey of participants through the duration of the project. Certain parameters - such as contribution rates, or the threshold above which roll-over takes place - will be flexible for savers to define.

You also asked about international examples of similar models. ‘Sidecar savings’ - a model whereby two accounts sit side-by-side and are funded through payroll deductions, is one category of a broader set of approaches to utilising the success of workplace pensions and payroll automaticity in helping people to build retirement assets, to also help them to meet other financial goals. The closest examples of which we are aware are in the USA. The AARP have conducted extensive quantitative research to understand demand and design preferences among US savers, and Prudential Financial recently announced a pilot programme with some employer clients, albeit without the ‘rollover’ functionality to formally link to pension saving. Direct comparisons are tricky due to regulatory and cultural differences, but we have a long-running dialogue with the AARP and others interested in these initiatives to share emerging lessons and findings across our respective projects.

We are also aware there has also been a move to creating some form of sidecar model within Kiwisaver. In both cases, New Zealand and the USA, the interest stems both from similar problems to ours around low levels of emergency savings in the population, but also from the fact that some pre-retirement access to DC savings is allowed in those countries and this has created a leakage problem. Sidecar in this setting is seen as a way to reduce leakage. We also see it as preferable to simply allowing access to DC savings because the latter approach can be administratively costly and can require pension schemes to hold inefficiently high exposures to liquid assets relative to the optimal balance to meet retirement goals. There is also a third model for using pension assets to facilitate shorter-term liquidity, which is to enable people to use those assets as collateral for loans - this approach is potentially more relevant to ‘medium-term’ and slightly larger-scale liquidity challenges as opposed to very short-term emergencies.

A fuller description of some of the international examples across all three models, and some assessment of the pros and cons of those, can be found in the attached article, which our
Executive Director of NEST Insight co-authored with the World Bank. Please note that this is a working draft, pre-publication, and so should not be shared more widely.

For information, you can also find the various discussion papers we have published on ‘sidecar savings’ NEST Insight’s website. We would of course be happy to provide the committee with further information or to discuss any aspect of this project with them.

Pensions credits for carers

Pensions have historically been designed to fit a life course of uninterrupted full-time work in standard employment. Reforms to National Insurance such as the introduction of credits into the state second pension for carers and those claiming child benefit made the system more inclusive and indicated that the Government of the time accepted the principle that the economic contribution made by carers should be recognised in the system.

With the flat rating of the State Pension and private DC saving taking the place of second pillar saving for the bulk of the working population, the Government could consider whether caring responsibilities (both long term caring and childcare) should be recognised via the automatic enrolment system.

Groups such as Age UK and the Fawcett Society have advocated that the Government makes a monetary contribution into a qualifying auto enrolment account on behalf of a person who stops working to take on care responsibilities. In their 2016 report, ‘Closing the Pensions Gap’, the Fawcett Society recommend setting this as equal to the value of employer’s contributions at the earnings trigger level (£10,000), which would equate to £125 per year.

NEST does not have a determined view on any particular solution but is supportive of policy thinking to consider how better to support members who may take significant caring breaks. The issue is being explored by the Insuring Women’s Future taskforce, a cross-industry group set up by the Chartered Insurance Institute to improve women’s lifelong financial resilience and examine some of the underlying causes of women’s pension deficit, on which NEST is represented. We would be happy to provide more detail on the conclusions of this work once it is further advanced - likely towards the end of the year.

Kind regards,

Zoe Alexander

Director of Strategy, NEST Corporation

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