Department for Work & Pensions

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DWP loan to the National Employment Savings Trust

In my letter of 25th January 2017 I said I would respond in April to the Committee's request for more information on when NEST will repay its loan.

I thought the Committee might first find it helpful to have a brief update on automatic enrolment, and the work of the National Employment Savings Trust (NEST), before focusing on the funding arrangements between DWP and NEST.

<u>Automatic Enrolment</u>

I am once more pleased to report that the roll-out of automatic enrolment continues smoothly and successfully. The latest published figures from the Pensions Regulator show that as at the end of March 2017, almost 7.7 million employees have been automatically enrolled into a workplace pension by more than 500,000 employers. By 2018, we expect 10 million people to be newly saving or saving more into a workplace pension.

We are now well into the roll out to small and micro employers and have worked hard, together with the Pensions Regulator, to make this process as straightforward as possible for employers implementing automatic enrolment. Employers make their own choice about which pension scheme to use in order to discharge their statutory duties. To support them with this, the Regulator publishes a list of pension schemes that meet Master Trust Assurance Framework standards or are regulated by the Financial Conduct Authority, as well as providing links to schemes listed by the Association of British Insurers. The Pensions Regulator also provides freely accessible guidance to employers on choosing a pension scheme for their staff, including on the implications of different tax arrangements for the members. NEST is proving a popular choice for employers who are meeting their duties.

NEST

NEST was established to support the introduction of automatic enrolment by addressing a supply-side market failure facing small employers and those on low incomes. It has a Public Service Obligation to accept any employer that wishes to use the scheme; and was designed to ensure all employers had access to a low-cost, good quality pension scheme for their workers, in particular those with low and moderate incomes.

Since 2012, NEST has grown rapidly. By 31 March 2017, NEST had over 4.5 million members, of which over 2.7 million are active savers. NEST also has more than 327,000 participating employers and in excess of £1.6 billion of assets under management.

DWP financing for NEST

There are three funding streams between the DWP and NEST, all three of which are reported in the NEST Corporation's Annual Report and Accounts:

- a loan from the DWP to cover the initial costs of establishing and administering the NEST pension scheme, to be repaid eventually from the income NEST generates from charges on members as the scheme grows;

- a Public Service Obligation Offset Payment in the form of grant payments that reduce NEST Corporation's borrowing costs from the commercial rate of interest on the loan agreement to the Government's own cost of borrowing;

- a grant in aid to cover costs that NEST incurs as a Non-Departmental Public Body and which cannot be charged to Scheme members, such as dealing with Freedom of Information requests and providing answers to Parliamentary Questions.

DWP loan to NEST

At 31 March 2017, the loan from DWP stood at £539 million reflecting the costs of establishing and operating the NEST pension scheme, net of the charges to date raised from scheme members.

There are two such charges:

- an annual management charge of 0.3 per cent on the total value of a member's fund each year

- a contribution charge of 1.8 per cent on each new contribution into a member's retirement pot

As I explain in detail below, there are a number of uncertainties in forecasting the evolution of the loan balance, and its eventual repayment; and a series of requirements on NEST to provide and model the information necessary for DWP to manage the loan.

But, to summarise here for convenience, the latest forecast position is a breakeven point of 2026, at which point the loan balance would be £1,218 million and a loan repayment date of 2038.

Managing the loan

The terms and conditions governing the loan funding are set out in a loan agreement between DWP and NEST Corporation. The measures are designed to enable DWP to manage its financial risks and budgetary processes, while supporting the delivery of the NEST pension scheme.

The loan agreement is underpinned by a suite of models ("the loan model") that produce forecasts of the NEST pension scheme's funding requirements and loan repayment, based on projections of key drivers such as NEST membership, contribution levels, fund growth, interest rates and earnings assumptions.

The loan agreement requires the loan model and its assumptions to be reviewed annually. This is done by the Department and NEST Corporation through a joint working group. In practice however, the assumptions are under constant review and either DWP or NEST can call for a review of assumptions leading to an update of the funding requirement forecast at any point throughout the year. In line with the Macpherson Review the NEST model has recently been audited. NEST's internal auditors (Ernst & Young LLP) found that the associated quality assurance procedures were consistent with the recommendations set out in the HM Treasury's March 2013 Review of Government Models, *'Review of quality assurance of Government analytic models'.*

The assumptions behind the long term projections drive the length and size of the loan the Department makes to NEST Corporation. There are inherent uncertainties surrounding these core assumptions. These include market uncertainty (which affect NEST's market share, member volumes and the characteristics of members); macro-economic uncertainty (which affect the relative growth in incomes of members and the performance of global markets); and member behaviour (opt-out and cessation rates). As part of the annual assurance process, sensitivity analysis around key assumptions is carried out to view how changes to each affect the loan repayment date.

Furthermore, changes to the future pensions landscape could have an impact on NEST's overall revenue levels, including:

- the impact of upcoming policy changes such as the removal of the annual contribution limit and transfer restrictions on NEST from April 2017;
- the phased increase of statutory minimum automatic enrolment contributions (two scheduled increases in pension contributions - up to 5% in April 2018, and 8% in April 2019); and
- the impact of the pension freedoms and flexibilities introduced by the Government in 2015.

Finally, societal changes such as longer working lives, and consumer expectations and the demand for products that better suit their working lives are changing the broader landscape within which NEST exists.

The initial projections of NEST's funding requirements necessarily relied on research-based assumptions. However as automatic enrolment proceeds, these are being supplemented by increasing amounts of management information, giving a more robust baseline from which to forecast NEST's long term funding position more accurately. As this continues, alongside economic performance changes and possible policy changes, the annual forecast will continue to change (in either direction). The credibility of the loan model is now well established, using at least five years of actual data, including just one year of data and evidence relating to small and micro employers.

As a result, with automatic enrolment continuing to progress well, NEST's finances have now moved from a position of uncertainty to one where there is more stability in the forecast. When the roll-out of automatic enrolment finishes in February 2018, DWP expects NEST to be one of the biggest pension schemes by membership in the UK. The European Commission's decision on state aid in 2010 for NEST noted a wide range of possible scenarios for the length of the loan ranging between 20 and 38 years.

Based on all the assumptions set out above, I expect NEST will become self-financing within the European Commission's estimated range. As I recorded earlier, the latest forecast position is a loan repayment date of 2038.

<u>2017 Review of Automatic Enrolment</u>

During 2017, we are conducting a review of automatic enrolment. The review will not consider the operational structure of NEST, or the loan. Instead, it is a broader look review of the coverage of automatic enrolment, and aims to build a strong evidence base on which to make decisions on future contribution rates. All of this will, of course, be of interest to each automatic enrolment provider, including NEST. We intend to lay a report before Parliament by the end of 2017. I propose to provide a further update to the Committee, once this year's review of automatic enrolment is complete.

I hope the Committee finds this information helpful.

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