Default funds with high charges should not be permitted in the new auto-enrolment market; otherwise millions of employees will suffer

LONDON Thursday 11 October: ‘Caveat Venditor: The brave new world of auto-enrolment should be governed by the principle of seller not buyer beware’, is published today by the Pensions Institute at Cass Business School. It examines the default funds, which an estimated 90-97% of private sector employees will use under auto-enrolment, and it raises serious concerns about the continued use of older funds with ‘toxic’ charges.

Key findings:

1. There is a 100% difference in the pensions members achieve between the lowest and highest charging defined contribution (DC) default funds.

2. An estimated 90-97% of employees auto-enrolled into DC schemes will use the default fund, which means that their pension outcomes will be a lottery unless the government, regulators and industry ensure all members benefit from default funds that offer good value for money relative to contributions paid.

3. Employees do not choose their employer based on the quality of the pension scheme. Nor do they have any influence over the charges and asset management quality of the schemes their employers provide.

4. Employees are passively auto-enrolled. They are not knowingly financial services ‘customers’; instead they are ‘buying blind’. Therefore the Financial Services Authority’s Treating Customer Fairly (TCF) approach, which is based on caveat emptor (let the buyer beware) is not appropriate. Instead, caveat venditor (let the seller beware) is the appropriate principle for auto-enrolment.

5. Charges for default funds in large new auto-enrolment schemes generally represent good value, but tens of thousands of employees currently are trapped in the funds of older schemes with high and disguised charges.

6. There is a very real danger that smaller employers will use these older schemes for auto-enrolment, potentially bringing millions of new pension investors into poor value default funds.

7. This is because the unintended consequences of the combination of auto-enrolment and the retail distribution review (RDR), which bans advisor sales commission on new schemes sold
from 1 January 2013, has resulted in an advice gap in the smaller employer market. At present, there is no mechanism to prevent the use of high-charging default funds for auto-enrolment.

**Professor David Blake, Director of the Pensions Institute, said:** “Fortunately there is time to address the problem of old high-charging funds, which for historic reasons are still widely used in the smaller employer market. These employers are not required to introduce auto-enrolment immediately but many companies will need to be prepared by mid- to late-2013.

“This report recommends the introduction of a kite-mark code that can help these employers find value for money schemes – and this is especially important if the employer is considered uneconomic (‘polluted’ in the industry’s language) for the advisory and provider market. A clearly signposted kite mark website for good quality value-for-money schemes – available to all employers, irrespective of their size and employee profile – would facilitate fair and equal treatment for all private sector employees, irrespective of how much they earn and the company for which they work.”

**Chris Daykin, Trustee Director of NOW: Pensions, the sponsor of the research, commented:** “‘Caveat Emptor’ or ‘let the buyer beware’ – the normal assumption that applies to the way financial services products are purchased – simply does not work for auto-enrolment because the buyer is the employer but the real customer – who is passively auto-enrolled – is the employee. As the report states the “customers” are therefore “buying blind”. Caveat Venditor represents a more appropriate principle for members of auto-enrolment DC default funds, because, as the report concludes – ‘let the seller beware’ – puts the onus on the seller to ensure its product will do what it says on the tin: to produce a lifetime income in retirement that is fair value relative to the contributions paid.”

**Morten Nilsson, CEO, NOW: Pensions commented:** “We recognise that policy and regulatory reform takes time, particularly if it requires consultation between the government, regulators and the pensions industry. However time is running out. It is essential the auto-enrolment market is fit for purpose for all employees, not just those who are employed by large companies with good advisers. The report helps to define what a good default fund should look like. An effective and well-promoted kite mark would help employers make the right choice of default fund and scheme going forward, as well as help eliminate poor practice relating to charges and investment governance.”

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*About the Pensions Institute*
The Pensions Institute is the only independent academic UK pension research organisation in the UK: www.pensions-institute.org.

About the report

This report analyses the DC default funds used for auto-enrolment from two main perspectives. The first is qualitative and considers the impact of the behaviour of sellers (the providers, consultants and advisers that determine the fund design and the supply and distribution chain) and buyers (employers and trustees on behalf of the members who have been auto-enrolled). The second is a quantitative analysis of the impact of charges and asset allocations on the size of pension outcomes in different default funds. A number of existing and new schemes are modelled using appropriately calibrated stochastic simulation models.

The authors of the report would point out that NOW: Pensions, which sponsored part of the research, did not seek to influence their findings and recommendations.


About auto-enrolment

Auto-enrolment is a hugely ambitious experiment on the part of the UK government. Its objective is to ensure that all private sector employees – with the exception of the very low earners – build up a private pension to supplement the state pension.

While the government sets the rules and regulations for auto-enrolment (policy), it is wholly dependent on private sector providers and advisers for the supply and distribution of schemes via employers to employees (delivery).

Auto-enrolment began on 1 October 2012 with the biggest employers and concludes in 2018 with the smallest (the employer staging dates timeline is provided here: http://www.thepensionsregulator.gov.uk/employers/staging-date-timeline.aspx). It requires employers to automatically enrol employees over the age of 22 into a designated pension scheme. Employees have the right to opt out.

A key regulatory requirement is that qualifying schemes must provide a default investment fund. This is because schemes cannot insist that auto-enrolees make an investment choice, since they have not actively chosen to join in the first place.

Auto-enrolment applies to ‘eligible jobholders’ who:

- Are not already in a qualifying workplace pension scheme;
- Are at least 22 years old;
- Are below state pension age;
- Earn more than £8,105 a year; and
- Work or ordinarily work in the UK (under their contract)

The rules require total minimum contributions of 8% based on earnings between £5,564 and £42,475 (‘qualifying earnings’) in the 2012/13 tax year. This 8% total comprises a contribution of 3% from the employer, 4% from employees and 1% tax relief. The contribution requirements will be phased in starting with a minimum of 2% of qualifying earnings, of which the employer must pay a minimum of 1%. Employers can choose to set higher minimum contribution levels.

About the sponsor, NOW: Pensions
NOW: Pensions is a multi-employer trust with a long term total expense ratio (TER) of 0.3% (including all charges admin and investments). The investments are managed by NOW: Pensions Investments, a subsidiary of ATP in Denmark. The administration is carried out by Paymaster, an established UK third party administrator.

The NOW: Pension Trustee Directors, whose role is to safeguard the interests of members, comprises well-known industry figures with different areas of expertise:

- Nigel Waterson, former Shadow Pensions Minister
- Christopher Daykin, former Government Actuary
- John Monks, member of House of Lords and former General Secretary of ETUC and TUC
- Win Robbins, former Head of European Fixed Income at Barclays Global Investors
- Lars Rohde, CEO of ATP Group
- Imelda Walsh, former Group HR Director of Sainsbury’s

NOW: Pensions is committed to developing a better workplace pension provision in the UK by offering a simple, systematically risk managed, cost efficient and high performance pension product that delivers better retirement savings for UK employees. With over 45 years’ experience providing Denmark’s working population with stable and consistent pensions returns, NOW: Pensions is set to transfer the knowledge acquired in Denmark to the UK pension market. Charges are just £1.50 per month administration charge (reduced administration charge of £0.30 - £1.00 to be applied during auto enrolment phasing for lower earners) plus a 0.3% annual product investment management charge, with no hidden charges.

NOW: Pensions is a subsidiary of Arbejdsmarkedets Tillaegspension (ATP). ATP manages the Danish Labour Market Supplementary Pension – a statutory pension fund. It was established as an independent entity in 1964 with the objective of ensuring a greater retirement income for the Danish population. ATP has since developed to become the largest pension fund in Denmark. Together with the tax-financed basic state pension, ATP provides basic income security in old age for the Danish population.

ATP covers almost the entire Danish population representing 4.7m members and 160,000 employers. In addition to the ATP Scheme, the ATP Group administers a number of pension and social insurance schemes, including several for the Danish state.

The ATP Group assets amounted to approximately DKK 579 billion (GBP 65bn) and DKK 74 billion (GBP 8.3bn) reserves at 31 December 2011. ATP invests in a wide variety of assets globally. Investment categories are broadly: equities, interest rates, credit, inflation and commodities.