

Stakeholder pensions

Financial Services Consumer Panel response to:
Department for Social Security Green Paper, 'A new contract for
welfare: partnership in pensions'

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Summary

1. The Panel welcomes:

- i. the commitment to increase access to pensions for all;
- ii. the decision to introduce CAT standards for stakeholder schemes, and to make them compulsory;

While supporting the objective, the Panel believes it will not be achievable without a number of changes and makes the following recommendations for consideration:

- a. The introduction of an additional benchmark regarding the suitability of the product for the individual. This is to ensure that any recommendation for a stakeholder is only given after considering aspects such as income levels, financial commitments, and any existing pension provision. *(paragraph 4)*
- b. That the Government review all existing legislation and Inland Revenue Rules impacting on pension provision and seek to reduce complexity and improve comparability between different types of provision *(paragraph 6)*
- c. That the Government conducts research into how independent and tailored advice can be provided to the target group at a reasonable cost. *(paragraph 8)*
- d. The whole decision tree concept and process should be subject to urgent and rigorous consumer testing and research. *(paragraph 9)*
- e. That a generic advice scheme for pensions is piloted, perhaps run through local Citizen Advice Bureaux or Money Advice Centres. This will need to be adequately funded. *(paragraph 10)*
- f. The Government and FSA should promote a consumer education programme to be run in conjunction with the generic advice centres, colleges, universities etc. The education programme must cover all types of pensions not just Stakeholders. *(paragraphs 10 & 18)*
- g. Employers offering their employees a Stakeholder scheme should provide a “health warning” explaining that their scheme may not be the best for all individual employees. *(paragraph 12)*
- h. The Government should strongly encourage employers to contribute to Stakeholder schemes and to promote the tax advantages available. *(paragraph 16)*
- i. That the Government conducts research on the likely impact of Stakeholder pensions upon existing occupational schemes, followed by an extensive employer monitoring programme to provide early warning of any

significant moves away from occupational schemes to Stakeholders. A monitoring programme should be established to inform any future decision regarding compulsion for employers. (*paragraph 17*)

j. An employee monitoring programme to be instituted to measure and track the level of pension provision by younger age groups. This will need to inform any future decision regarding compulsion for employees.
(*paragraph 19*)

k. That a guaranteed minimum benefit is introduced to the Stakeholder concept in order to address consumer concerns over the uncertainty of future pension provision. (*paragraph 24*)

l. Consumers should be offered a one-stop-shop for complaints. Under the current proposals responsibility for handling complaints is split between OPRA and the FSA and this will inevitably lead to consumer confusion and detriment. (*paragraph 25*)

m. Annual statements should include an indication of the real value of pension benefits at retirement. (*paragraph 29*)

Introduction

This paper is the response from the Financial Services Consumer Panel (“the Panel”) to the DSS Green Paper entitled *A new contract for welfare:*

Partnership in Pensions. The Financial Services Authority (FSA) established the Consumer Panel to advise the FSA Board on the interests and concerns of consumers and to report on the FSA’s effectiveness in meeting its statutory objectives. There are eleven members of the Panel representing a broad range of consumer interests. The Panel is independent of the FSA - it can raise its own concerns, initiate its own research and publish its own reports.

Overall concept

2. The Panel broadly welcomes the proposals, in particular the commitment to increase access to pensions for all and especially for those on fluctuating incomes or with several different jobs or who move into and out of the labour market on a regular basis. Women as a group have low levels of existing pension provision and would particularly benefit from these provisions.
3. We also welcome the compulsion to have benchmark standards for Stakeholder schemes but note that there are no clues as to what the required standards will be. Pension providers have a clear self-interest in criteria that are not too strict. On the other hand, we would like them to be as demanding as possible. We are concerned about the “halo” effect of benchmark standards being perceived as a Government endorsement. The public is still not familiar with the concept of benchmark standards and the Government must ensure that sufficient effort is dedicated to educating consumers about the value and purpose of them. **The Panel strongly feels that there must be a requirement for a “suitability” assessment to be made.** Just because a Stakeholder scheme meets the benchmark standards suggested in the paper, it doesn’t necessarily mean that the scheme is either suitable or the best option for the individual investor. The suitability test should ensure that any recommendation for a stakeholder pension has been arrived after considering aspects such as the employees current and likely future levels of income, their financial commitments and debt, any existing pension provision and likely future benefits from this provision. Decision trees must identify the factors consumers need to take into account and enable individuals to assess the suitability of products offered without advice. Our concerns on suitability and the need for advice are explored in paragraph 8.
4. However, the Panel has some major reservations regarding certain other proposals. These are discussed under the headings below.

Complexity of pension system

5. The Government's clearly stated aim to use Stakeholder pensions as a means of simplifying arrangements for and encouraging take up by those consumers with little or no existing provision is laudable. We remain seriously concerned about the underlying complexity of the pension system. We believe that the Government's intentions may not be realised unless action is taken to address the wider complexities and simplify the legislation and tax rules which affect state, occupational and personal pensions. **We recommend that the Government review the existing pension laws as a matter of urgency in order to reduce complexity, and encourage comparability between different types of provision.** Much more needs to be done for those consumers within the target income group who already have some kind of existing provision. The confusion that the current system causes can be judged from PIA research into the persistency of personal pensions where it was found that after four years, over a third of policyholders had lapsed. This not only suggests that consumer understanding of pensions is extremely low, but also that the motivation for retaining a pension is not particularly strong. The Green Paper is written as though everybody eligible for Stakeholder schemes will start with a clean pension background, i.e. that they will have no existing arrangements to complicate matters. In reality many of the target group could have a wide range of existing pension arrangements and unless action is taken now the objective of simplifying arrangements for them will be jeopardised.
6. On a related topic, the Panel also welcomes the introduction of LISAs as a means of providing much needed flexibility within the pensions framework but at the same time feels that these products further complicate an already complex environment.

The need for advice

Tailored advice

7. In principle, consumers should be empowered to make valid and informed choices about their personal financial circumstances and long term needs whether they buy direct or on the basis of advice. Generic advice and information is needed to help people make those decisions. Faced with the current complexities, the Panel feels that, the assumption that people will routinely be able to buy pensions without specialist advice, and particularly without suffering detriment, is fundamentally flawed. Stakeholder schemes will only be taken up if suitably flexible arrangements are offered to persuade highly diverse groups to make appropriate choices and contribute. The assumption that low/middle-income earners share similar characteristics and that one approach will fit all is wrong. Different groups will need different methods to reach them and we think that the proposals should reflect this need for flexibility. The introduction of benchmark standards should ensure that all schemes offer fair, basic value but as proposed they will not give any indication of the suitability of the scheme for the individual. Many consumers will have several existing pension arrangements and the portability (or lack of portability) of these existing arrangements will further confuse an already complex system. The need for tailored consumer advice is not merely confined to the decision whether to participate or not in a Stakeholder scheme, but also comes to the fore as consumers approach retirement and need advice on the purchase of annuities. While independent advice offers one solution to consumer confusion, there are problems associated with this route – i.e. who is to provide the advice, at what cost, and is it accessible to all. There is also the possibility of commission bias where advice is given between Stakeholder pensions and other personal pensions. In any case, for some consumers putting money into a Stakeholder pension may not be the most suitable choice. For example, those on low incomes with dependants might be better off buying term

insurance. Those consumers for whom it would be wrong to go down the Stakeholder channel without advice may also be those that can least afford to pay for the advice. **The Panel recommends that more research should be conducted by Government to determine how affordable, tailored advice could be achieved and consumers empowered to take effective decisions on the basis of good generic information.**

Decision trees

8. The Paper makes great play of better information being provided to employees but information in itself does not guarantee that an informed decision is made. The decision tree idea is likely to run into difficulties when faced with the myriad of different personal circumstances. For instance, how would the decision tree approach work for someone who currently has a personal pension and who wishes to change to a Stakeholder scheme? There is obviously a need for specific advice in these cases and indeed it is difficult to identify any situation in which existing pension arrangements are present where tailored advice would not be in the best interests of the consumer. The Panel feels that there is a real danger that decision trees will be over-simplified in order to make them understandable to consumers and in the process of simplification they will not always reflect the best options for individual consumers. **The Panel strongly recommends that the whole decision tree concept be piloted and tested by rigorous consumer research as soon as possible.** The success of Stakeholder pensions hinges upon the effectiveness of these decision trees and if they are found not to offer consumers generic advice which is both suitable to their personal circumstances and easily understandable some other method must be urgently sought (see paragraphs 4 and 23).

Generic advice

9. The proposals for sources of generic advice are also not sufficiently developed. In reality, many consumers will need to be reassured and given helpful advice regarding their options. It is indisputable that some freely available source of generic advice is vital to the long-term success of the proposals. One possible source of this generic advice service could be the Citizens Advice Bureaux and local money advice centres. **This service must be piloted now with adequate funding in order for any problem areas to be flushed out in time for the launch of Stakeholders. The provision of generic advice must also be combined with a comprehensive consumer education programme.** Together they will help to avoid the mistakes that ultimately led to the personal pension mis-selling scandal.

Choice

Employer choice

10. The Panel applauds the requirement on an employer to offer a Stakeholder scheme to all employees not eligible for membership of an occupational scheme. However, it has some concerns that employee choice may actually suffer under the current proposals. Employers are only compelled to offer one Stakeholder scheme to employees. Both the generic advice given to employers regarding which type of scheme to offer and the final decision as to which scheme is offered by the employer are not subject to regulation. The employer may also not have sufficient understanding of the issues to make the final choice of scheme. The Panel feels that the net effect of this is that employers will offer the scheme that is best for them, perhaps as a result of marketing incentives by providers, and not necessarily best for their employees. There appears to be nothing in the proposals to prevent this. Having said this it is recognised that the benchmark standards should ensure that any scheme offered is competitive on costs and flexibility.

Employee choice

11. Although employees will be entitled to join an alternative scheme to that offered by their employer, unless clear information regarding this option is provided and vigorously promoted, experience suggests that consumers are unlikely to shop around. **In order to promote informed choice, it should be a requirement that employers give a “health warning”** along the lines that their recommended scheme may not be the best for all individual employees but by virtue of the benchmark standards does represent a reasonable and competitive deal on costs and flexibility.

Effect upon Occupational Pension Schemes

12. Following the abolition in 1988 of the requirement on employees to join occupational schemes as a condition of their employment, there has been a gradual decline in membership of occupational schemes. The Panel agrees with the Government that the provision and membership of occupational schemes must be encouraged. The Panel also recognises that the changes in work patterns since 1988 mean that a return to compulsory membership may not be in the best interests of all employees. The Panel therefore welcome the proposed measures to encourage membership of these schemes by allowing employers to require employees to be members of their occupational schemes subject to a right for employees to opt-out under certain defined conditions.

13. However, the Panel has particular concerns regarding the effect of Stakeholder pensions upon occupational pension schemes. As the Green Paper makes clear, those employers who do provide occupational schemes make a significant contribution towards them. Under the current proposals there is no compulsion on employers to contribute to a Stakeholder scheme and the danger is that employers currently offering occupational schemes will see Stakeholder schemes as an opportunity to reduce costs by reducing their overall commitment to pension and associated risk benefits for their employees. The move away from

occupational schemes based upon the employees' final salary to money purchase schemes shows that many employers are likely to take advantage of an opportunity to reduce their commitments.

14. The potential for this is exacerbated by the proposed upper contribution limits of £3,600 per annum or 100% of earnings if less. Using a rule of thumb of a 10% combined employer/employee contribution rate, Stakeholder schemes could cater for all a company's employees earning up to about £36,000. At this level the majority of employees would be eligible and therefore the incentive and temptation for an employer to drop their existing complex and expensive arrangement and change to the cheaper and simpler Stakeholder option would be high.

15. Having stopped short of compulsion, **the Panel feels that the Government must strongly encourage employers to contribute towards their recommended Stakeholder scheme. The significant tax advantages for employers under occupational schemes are also available under Stakeholder schemes and these should be vigorously promoted to employers.**

16. **The Panel recommends that the Government conducts extensive research on the likely impact of Stakeholders upon occupational schemes and follows this with a detailed employer monitoring programme so that any substantial move away from occupational schemes is identified quickly.** The employer monitoring programme should inform any decision as to whether compulsion for employers should be introduced in the future.

17. At the same time, it is just as important that employees themselves are not "encouraged" away from existing occupational schemes to Stakeholder schemes by employers playing upon the simplicity of these schemes and the "halo" effect of Government sponsorship and high media coverage. **The Government and the FSA should heavily promote education about all pensions not just Stakeholder schemes.** There is a real

danger of making Stakeholder schemes the aspiration rather than occupational schemes. Work based learning is extremely important in this respect but educational provision about pensions should include sixth form colleges, adult centres, universities etc.

18. The Panel also recommends that an employee monitoring programme be introduced to measure any changes in the level of pension provision made by those in the younger age groups who have proven to be especially difficult to attract into schemes. The employee monitoring programme should inform any decision as to whether compulsion for employees should be introduced in the future.

19. The Panel welcomes the proposals to strengthen the current pension framework as set out on page 72 of the Green Paper.

Affordability

20. What is still left unresolved by the proposals is whether the vast number of people earning less than £18,500 will be either able or inclined to fund an adequate pension whilst meeting the requirements of their daily life. The Panel feels that this is a particular problem for those middle-earners aged between 18 and 40 where a mixture of major lifestyle changes and diverse attitudes to financial provision are likely to have an impact. Some of the groups where these problems may be manifest are highlighted below:

- Those on the cusp of the Stakeholder proposals, i.e. just under or over the £9,000 lower limit.
- Those aged 25 to 35. This is generally an expensive period of life with a wide range of commitments including young children and relatively high mortgage payments.
- Students entering the workforce with large debts as a result of student loans. How will this group be persuaded to part with money to fund such a

long-term investment whilst a sizeable proportion of their earnings will already be earmarked as loan repayment?

- Those aged 18 to 30. Many people within this group, especially at the younger end of this range, have different priorities, aspirations and attitudes towards financial services in general and provision for their old age in particular. Many occupational schemes already have great difficulty in persuading younger employees to join and short of compulsion, which in itself doesn't solve the affordability question, the situation is unlikely to improve with the introduction of Stakeholder schemes.
- Those making Child Support Agency payments will already have substantial existing demands upon their earnings that may severely inhibit both the capability and desire to fund a Stakeholder pension.

21. It is unrealistic to suppose that low/middle-income earners will automatically have the ability or desire to fund their own pension. Some form of significant fiscal and other encouragement to employers to contribute towards the Stakeholder scheme (see paragraph 16) would take some of the financial burden off those who can least afford it and perhaps encourage them to participate.

22. If the decision tree approach is finally adopted, then careful consideration must be given to building in an allowance for affordability. Any decision tree should ensure that short-term savings commitments are adequately covered *before* recommending people to join long-term investments such as a Stakeholder scheme (see paragraph 9). If this affordability allowance is not factored into the decision tree process it will inevitably lead to a high proportion of stopped contributions and perhaps lapses as people find they can no longer afford to meet their payments. Although allowed for in the Stakeholder concept it is obviously desirable if the incidence of stopped contributions is minimised.

23. The Panel is disappointed that the proposals do little to address the current general uncertainty surrounding future pension provision. In

particular, there is no requirement for Stakeholder schemes to offer minimum guaranteed benefits. **The Panel considers minimum guaranteed benefits to be vital in a period of prolonged low interest rates to ensure that the final pension benefits are adequate and strongly recommends they are included in the Stakeholder concept.** Low interest rates mean the amount invested has to be considerable in order to ensure an adequate return. This will have a direct effect upon the affordability of the proposals for many low/middle-income consumers, as it effectively prices them out of making adequate pension provision.

Regulation and redress

24. There are significant issues attached to the proposed regulatory regime. Firstly, a two-tier system of regulation increases the potential for regulatory loopholes to appear. More importantly from the Panel's perspective, the split of responsibilities between the Pensions Ombudsman and the Financial Services Ombudsman will lead to increased consumer confusion regarding complaints and redress. **The Panel recommends that consumers be offered a one-stop shop for complaints.** At least, a mechanism for joint investigations by the two organisations should be established so complainants do not have to deal simultaneously with two separate organisations dealing with different aspects of the same complaint.
25. As Stakeholder schemes will be sold directly to employers, the Panel seeks confirmation that the redress options available to individual scheme members will not be adversely affected. The Panel is aware of the current difficulties that the PIA Ombudsman has handling complaints from individual members of Group Personal Pension Schemes or Group Private Medical Insurance Schemes.

Other comments

26. The Panel expressed concern at the lack of concrete transitional arrangements and recommendations in the Paper. Should pension providers be selling personal pensions to low/middle-income customers between now and the introduction of Stakeholder schemes? If firms do continue to sell personal pensions to consumers who would inevitably be better off with a Stakeholder pension does this constitute pensions mis-selling and are these consumers entitled to redress and transfer to an appropriate Stakeholder scheme without loss of benefits? While the Paper mentions that the Government will be looking to the personal pensions industry to facilitate transfer into Stakeholder schemes where it is in the client's interest, the real issue will be at what price and on what terms.
27. There are potential conflicts of interest where affinity groups act as agents/introducers of alternative schemes to that offered by the employer. Any affinity group will certainly use their relationship with employees to persuade them to join their scheme. Therefore, employees may make a decision with their heart rather than their head and the potential for them to be influenced towards what may not be the best scheme is greatly increased. This will be extremely difficult to monitor through the existing regulatory framework as the FSA may not have a relationship with those who are in closest contact with customers.
28. Finally, **the idea for annual statements of pension benefits is warmly welcomed with the proviso that any such statements must include an indication of the real value of pension benefits at retirement.** Our predecessor, the PIA Consumer Panel, commissioned quantitative and qualitative research last year on customer's attitudes to pension statements. The qualitative research showed that consumers were very confused about the information on their pension statements, particularly the information included on statements as a result of Inland Revenue requirements. Both studies revealed a strong demand for clear information on the future projected value of pensions.