The Financial Inclusion and Markets Centre

Promoting finance that works for the economy, environment, and society

The Second Pensions Commission

Pensions 2050: Evidence and Future Priorities

Submission by The Financial Inclusion and Markets Centre (FIMC)

About The Financial Inclusion and Markets Centre

The Financial Inclusion and Markets Centre is a dedicated unit of the Financial Inclusion Centre which focuses on financial services policy and regulation, financial market reform, and evaluating the economic, environmental, and social utility of finance. The new unit also covers work evaluating the impact of developments at the intersection of finance and technology including AI.[1]

[1] About | The Financial Inclusion Centre

Introduction

1. We are pleased to submit a response to such an important report. We would be very happy to provide further details on our submission or discuss any of the points we raise. If that would be helpful, please contact Mick McAteer, Co-Director, Financial Inclusion and Markets Centre mick.mcateer@inclusioncentre.org.uk
2. We think the Interim Report provides a very comprehensive and forensic analysis of the challenges the UK faces in building a fair and equitable, adequate, sustainable, and efficient pension system that works better for people currently not well served by the current system.
3. The work of the First Pensions Commission resulted in one of the few significant public policy successes of recent years through the establishment of autoenrolment (AE) and NEST. Millions of people that were not contributing to a pension are now doing so while NEST and charge caps introduced some real competition and value into the private pensions market for the first time.
4. But, as the Second Pensions Commission rightly highlights, conditions have changed since the publication of the First Pensions Commission Report and the foundation provided by those reforms now need to be built on. We have high expectations that the work of the Second Pensions Commission will also result in major achievements given the right political will and effective collaboration between relevant stakeholders.

The key challenges

5. We do not have the resources to provide meaningful input on all aspects of the Interim Report. So, we are focusing on the issues with FIMC's remit. We articulate our goals for the pension system as follows: if the pensions system is to work for everyone[2] it should be: safe and resilient; sustainable; fair, equitable, and inclusive; efficient and fit-for-purpose; and well- regulated and governed.
6. Creating such a system requires identifying and addressing the structural issues and barriers in the current system that are likely to undermine the meeting of those goals. FIMC's assessment identifies the following barriers and challenges:
   - Low pensions adequacy for millions of citizens, with a focus on specific vulnerable groups
   - Unfairness and inequity in the system
   - Unsuitability of the current pensions infrastructure for millions of underserved citizens
   - Chronic market inefficiencies, high costs and poor value for money caused by fragmentation, poor design, and conflicts of interest in the system
   - The transfer and individualisation of financial, market, and intertemporal risk within the system
   - Restricted availability of independent advice and information to support effective pension decisions

[2] Not just scheme members but other citizens, the real economy, and the environment.

- Standards of governance, conduct of business and 'consumer'[3] protection regulation, transparency in the pensions system, and the need for enhanced engagement and representation in the pensions system
- Managing macro and micro prudential risks in the pensions system including due to the emergence and application of AI
- The fragmentation inherent in the current 'three peaks' regulatory system – TPR, FCA, and Prudential Regulation Authority (PRA)[4]
- Environmental risks - both in terms of the harm caused by environmental degradation to the pensions and wider financial system and vice versa, the harm caused by the financial system to the environment
- The potential impact of AI on labour markets and pensions policy

7. We briefly cover these challenges and barriers in turn, below. The scale and nature of the challenges requires combined, concerted efforts on the part of Parliament, government, the regulatory system (The Pensions Regulator, Financial Conduct Authority, and Bank of England/ Prudential Regulation Authority), civil society organisations including trades unions, employers, and the financial services industry. We hope the work of the Second Pensions Commission will provide the necessary spur for these stakeholders to act.

Pensions adequacy, unfairness and inequity

8. As mentioned above, we think automatic enrolment (AE) and the establishment of NEST is one of the few significant public policy successes of recent times. But, there would seem to be a consensus that, unless there are improvements in the level of foundational state pension provision, then the current minimum employer and employee contribution rates are unlikely to be enough to provide a decent income in retirement for millions of workers currently in the AE system. So, there is a strong case for reviewing employer and employee minimum contribution rates.

9. However, increasing total contribution rates on their own would not address the pensions inadequacy of: lower income workers in the AE system who may not be able to afford higher contribution rates; and groups who are excluded from the system.

10. The Interim Report documents with striking clarity the position facing financially vulnerable groups. The level of pension provision amongst certain groups eg. the self-employed, women, carers (mostly women), certain Black and minoritised ethnic (BAME) groups, people with a disability, and renters is very worrying. For example:

- The percentage of the self-employed reporting saving into a pension in a typical month fell significantly from around 50% in the late 1990s to less than 20% at present (new analysis shows that in 2023-24 pension participation was only 4% for individuals who received income from self-employment only).
- There is a clear pensions gender divide. In cash terms, among those aged 55 to 59, median uncrystallised pension wealth was £81,000 for women compared with £156,000 for men. Women are much more likely than men to be economically inactive because of caring responsibilities which obviously affects their ability to amass private pension provision.

[3] Consumer in this case covers employers scheme members and personal pension plan holders.
[4] Plus the other parts of the regulatory system – the Ombudsmen schemes and FSCS/ PPF

- More than half of people with a disability at age 46 have no pension wealth at all.
- Black / African / Caribbean / Black British pensioners have around 30% lower gross income than White ethnic groups. With regards to occupational pension provision, Asian and Black ethnic groups have around half the level of income as White ethnic groups.
- There are serious regional disparities, too, due to levels of economic inactivity. These pension deficits are exacerbated by significant disparities in wealth and assets, prospects for inheritances, and the misguided belief that property will be a 'get out of jail card' for many.
- Intergenerational unfairness seems embedded in the system with valuable defined benefit schemes no longer available to younger citizens.
- In addition to carers, workers in irregular or intermittent work (including 'zero hours contracts'), by definition, are more likely to find it difficult to accumulate adequate private pension provision in their own right to supplement state pension provision.

11. We do not generally comment on the use of state resources but it is difficult to see how low pensions adequacy and inequity can be meaningfully addressed without state intervention to help these groups build up higher private pension provision in their own right or by providing better direct state pension provision for these groups. Interventions such as financial education designed to encourage people to save more will not address the fundamental point that these groups do not have, and are unlikely to ever have, sufficient individual resources to accumulate adequate pension benefits in their own right. It would require the state directing additional resources towards their needs.

12. One potential source for these additional resources is the current system of pensions tax relief. We argue that the current deployment of tens of £billions of pensions tax relief is inefficient. As the Interim Report points out, the estimated net cost of pension Income Tax and NICs relief was £53 billion in 2023-24, up from £31 billion (estimated in 2004-05 values). But, it is not clear that the figure for the overall cost of tax relief appropriately estimates the cost to the state. There can be a significant gap between the point at which a person receives tax relief on pension contributions and when they come to pay tax on the pensions they receive.

13. As well as subsidising an inefficient private pensions and investment industry,[5] the better-off attract the bulk of the tax relief. Two-thirds of up-front income tax relief goes to higher and additional rate income taxpayers. Despite the scale of resources deployed on pensions tax relief, it is not even clear that the use of pension tax relief encourages genuine new pension savings amongst the better-off, who attract the bulk of the relief, rather than just encourage them to divert from less tax-advantage savings to tax-advantaged pension savings.[6]

14. The fact that we see worrying low pension adequacy amongst vulnerable groups, and the better off attracting the bulk of state resources assigned to supporting pension provision in the form of pension tax relief (providing limited or no added value in terms of encouraging new pension saving), is surely undesirable.

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[5] Pensions tax relief increases the scale of pension assets from which to extract investment management, product, and advice fees.

[6] See, for example: [The effect of tax incentives on retirement saving] and [Full article: The effectiveness of tax incentives to encourage private savings]

15. Active consideration should be given to capping pensions tax relief for higher and additional rate taxpayers and using the savings to boost the pensions of financially vulnerable groups with low levels of pension adequacy. There is no question that there would be administrative complications with reforming pensions tax relief due to the impact on legacy defined benefit pension schemes. But, the impact on legacy schemes should not be a reason for retaining a system which is inefficient and could be reformed to redirect resources towards supporting financially vulnerable groups.
16. Consideration should also be given to revising the current rules on withdrawing pension cash tax free, although less is spent on this benefit. It was estimated that this had a long run annual cost of £5.5bn with the better-off also attracting the bulk of this relief.[7]
17. Furthermore, consideration could also be given to reforming the application of National Insurance Contributions (NICs) to employers' pension contributions. This could also raise a significant sum of money depending on the nature of the reform.[8]
18. There are those who argue that reforming pensions tax relief, for example by making it flat rate, would be 'incoherent' and that there are better ways to raise resources more directly eg. through income tax reform.[9] This argument itself seems rather simplistic and limited.
19. The view that pensions tax relief should not be reformed might make sense if pensions was the only public policy crisis facing the UK that requires the deployment of significant additional state resources. This is clearly not the case.
20. In addition to tackling pensions inadequacy and inequity, other crises need to be addressed: growing demographic-related healthcare needs and lack of affordable, accessible and good quality social care; regional economic inequality; green transition needs; the lack of affordable, quality housing; and the state of physical and social infrastructure.
21. As mentioned, we do not comment on how and where the state should prioritise deploying the financial resources at its disposal. Nor do we have a policy line on whether the state should raise more resources directly via the tax system. However, we cannot ignore the fact that, if we are going to meaningfully address those priorities, deployment of substantial additional state-deployed resources will be unavoidable.
22. It could well be possible to use income tax reform and/ or reform to employers NICs just to address pension inadequacy and inequity. But, given the scale of the multiple crises, the requisite financial resources would have to be generated from number of different sources including direct taxation, current pension-related tax incentives and treatment of employers' pension contributions.
23. Moreover, as mentioned above, it is not even clear that pensions tax relief is effective at its goal of encouraging genuine new pension savings amongst the better-off. So, it is not clear why this should be retained in its current form as a mechanism for incentivising adequate pension provision. To be clear, we are not arguing that the total amount currently spent on pensions tax relief should be reduced rather that it should now be reframed as a mechanism for boosting the pensions of financially vulnerable groups.

[7] Raising revenue from reforms to pensions taxation | Institute for Fiscal Studies
[8] Options for levying employers' NICs on employers' pension contributions are set out here Raising revenue from reforms to pensions taxation | Institute for Fiscal Studies
[9] Raising revenue from reforms to pensions taxation | Institute for Fiscal Studies

24. To summarise this point, there are no easy choices here. Whichever mechanism is used to divert necessary additional resources will be politically and administratively challenging. But, protecting the huge sum spent on pension tax relief in its current format, which is also an ineffective policy tool, does not make sense.

Unsuitability of the current pensions infrastructure for underserved citizens

25. Individual pension incomes in retirement come from a combination of state/ private provision and pay-as-you-go/prefunded models.[10] The combination very much depends on the nature of an individual's employment. Individuals in employment and in the AE system (or in legacy DB schemes) should expect to see a higher proportion of their total retirement incomes coming from private/prefunded pensions than those vulnerable groups who rely more on state/PAYG provision.
26. If the goal of future pension policy is to increase the proportion of pension income excluded/underprovided groups receive from private/prefunded pensions then, at the risk of oversimplification, three conditions need to be met:
    i. they must have sufficient resources to put into the system to prefund future pensions (this could be addressed by redirecting state resources from inefficient use of pensions tax relief - see above);
    ii. there would need to be an effective mechanism for bringing them into the system as certain financially vulnerable groups do not have access to the AE infrastructure; and
    iii. the pension vehicles/schemes/products used to prefund future pensions must be fit-for-purpose, offer good value, and be trusted.
27. The needs of two distinct groups must be considered: i. lower-income and 'gig economy' workers (who are already included within the AE infrastructure); and ii. groups who are not included within the AE infrastructure such as carers and the self-employed.
28. Improving the position of those in the AE infrastructure is comparatively more straightforward. Their pension savings could be boosted by increasing the rate of pension tax relief they receive or providing direct annual cash top-ups to their pension pots. Moreover, more robust regulation to drive down the costs of running pension vehicles used by employers would enhance the value created by the additional pensions savings - see below.
29. But, this still begs the question of how to support those with low pensions adequacy and who are not within the AE infrastructure such as carers and the self-employed. To reiterate, they would need additional resources to be directed towards their individual pension provision, a mechanism for bringing them into the pension system, and effective pension vehicles to generate future pension income.
30. With regards to additional resources, these could be generated from reforms to pensions tax relief and other measures - see above.
31. With regards to bringing excluded groups into the pension system, autoenrolment in its current format (based around an employer administering deductions and contributions) would not work for groups such as carers and the self-employed. So, some

[10] Of course, there are other potential retirement income assets to consider such as housing wealth and savings such as ISAs. But, for now, we are focusing on the income from pensions.

complementary mechanism to play the same role as AE does for workers would be needed.

32. With regards to private sector pension vehicles, more robust financial regulation and the establishment of NEST has driven major improvements in the costs of private pensions. Both the level and structure of charge have significantly improved. Personal pension products with charging structures that penalised regular monthly pension savers for wanting to transfer their pension contributions to a different provider or temporarily suspend contributions are more or less a thing of the past (although there is still an issue with some legacy pensions).

33. Nonetheless, even with these improvements, it is important to acknowledge that the private pensions market is not interested in serving, or is unable to serve, the needs of the large numbers of financially vulnerable groups highlighted here. The current private pensions model (during both the accumulation and decumulation phases) is still generally structured to serve citizens who have already accumulated sizeable pension assets or citizens with comparatively stable, predictable work patterns who can expect to accumulate sizeable pension assets over time. This is not a criticism of the market, just a recognition of the commercial realities when private, for-profit/shareholder-owned institutions play such a key role in pension provision.

34. So, taking into account the unsuitability of the current AE infrastructure and pension vehicles/products, we think there are three broad options for boosting the future retirement incomes of excluded and underpensioned groups:

i. A mechanism could be established to enable them to prefund, with state support, some of their future retirement income by investing through their own pension pot with a very low cost accredited NEST-type scheme (this would address the limitations of the private pension market outlined above).

ii. The state could create a ring fenced scheme to prefund a proportion of retirement income to supplement PAYG state pension entitlement. Participants would be allocated their own personal state pension accounts with state top-ups paid into accounts (in effect, creating a new prefunded version of the Additional State Pension.

iii. A future state pension top up could be 'promised' but paid by the state on pay as you go basis, not prefunded.

35. The first two options have an advantage in that at least the future income in retirement would be prefunded and not exposed to the risk of promises not being honoured by future governments.[11] Option 3, on the face of it, has the advantage of not exposing these groups to the intemporal market risks inherent in prefunded investment-based pension schemes - see below. However, with option 2 it would, of course, be possible for this new ring fenced scheme to offer minimum guarantees to citizen account holders to provide downside risk protection (in effect, creating a better version of the old with-profits funds).

36. For groups currently not included in the AE system, we cannot say whether relying on more attractive incentives to save (such as higher pensions tax relief or annual cash top ups) would cause them to save more into their private pension. So, as with employees, some equivalent to autoenrolment may be necessary. For example, the self-employed could be automatically enrolled into the pension system by requiring them to make

[11] Of course, future governments could also change the taxation of pensions in receipt. But, we think this is unlikely to affect people in receipt of comparatively low pension incomes in retirement.

contributions during their annual tax self-assessment submissions but with the option to opt out.

37. Others may propose alternative models. But, whichever model is chosen, this would need to be supported by access to trustworthy, objective, accessible pensions advice - see below.

Costs, performance, efficiency, and value for money

38. We are very pleased to see the Second Pensions Commission consider the issue of costs. Costs matter; the more costs and fees extracted from pensions, the more individuals have to contribute to their pension to produce the same retirement outcome. If we want each £ of pension savings (and state subsidies) to work as efficiently as possible, then it is critical to put downward pressure on the charges and fees levied by the pensions, insurance, and investment industry. While we are seeing greater concentration in the master trust market and amongst pension schemes, the current market of service providers is fragmented and oversupplied with asset managers, funds, and products[12] and provides inconsistent levels of value.

39. To be fair, we have seen real progress in driving down charges in the private pension market as a result the pension charge cap and the establishment of NEST. More could have been done to drive down charges even further but the progress made should be celebrated and protected.

40. But, we are concerned that a number of developments - a probable rise in the pension charge cap, the Value for Money (VFM) agenda, and moves to drive pensions to invest more in expensive private assets - threaten to reverse those gains to the detriment of pension savers.

41. As the Commission points out: '*there is widespread differential pricing, with over two-thirds of multi employer schemes charging different prices to different employers and therefore identical savers who just happen to work for different companies. These charges vary from around 0.1% for some employers to over 0.5% for other employers. This behaviour was foreseen by the first Pensions Commission and it is difficult to see a justification for such a spread of outcomes.*'

42. The Commission also pointed out that: '*The market created to deliver the second pillar of the UK's pension system is different from that anticipated by the first Pensions Commission. The Government did not introduce the National Pensions Saving Scheme (NPSS) as a default scheme but decided to leave the market more open.*'

43. The decision to create a more open market of private pension providers limited the potential for NEST (originally conceived as the NPSS) to deliver value for the maximum number of citizens. To be sure, price regulation in the form of charge caps enhanced efficiencies and brought down charges where competition and market forces singularly failed to do.

44. But, even better value could have been delivered if the original conception of NEST had been delivered. The Second Pensions Commission also reminded us that: '*some very large default fund managers, like AP7 in Sweden, are able to operate with much lower charges than the UK – AP7 has charges closer to 0.1%*.'

12 Note that with respect to specific parts of the market, the issue is overconcentration. The master trust market is a clear case in point.

45. Therefore, we would argue that an even greater focus on low costs and efficiency is needed. We support the general principle that economies of scale should be promoted as this should deliver benefits for scheme members by improving efficiency and keeping down costs. Of course, greater scheme consolidation needs to be accompanied by improvements in regulation, governance, accountability, and transparency. The larger the schemes, the greater the potential negative impact of poor decision making and adverse events. We have a number of concerns about the regulation and governance of master trust schemes, see below.

46. Note that we support generating economies of scale because of the potential for creating cost efficiencies, not better investment performance. With regards to investment performance, the available evidence does not support the view that scale necessarily leads to better investment performance. Indeed, The Pensions Regulator's own research found that, while scale does indeed support cost-efficiency, '*The current UK evidence linking scheme size with gross investment returns is weak*'.[13] We cover the issue of the relationship between costs and investment performance, below.

47. It is concerning that the potential benefits of creating greater economies of scale could be undermined by moves to weaken the charge cap on workplace pensions to further facilitate greater investment in private assets - a goal of the Government.[14] This measure was recommended by the Productive Finance Working Group - a group dominated by industry representatives.[15] The DWP weakened the charge cap with regards to occupational schemes so that performance fees do not need to count towards the 0.75% charge cap. The FCA is to consult on aligning the rules on contract based pension schemes with those of the DWP.[16]

48. Investing in private assets such as private equity and infrastructure is more costly than investing in tradeable, liquid assets such as equities and government bonds. Some will argue that these higher costs would be more than offset by the opportunity for superior investment performance provided through investing in private assets. But, there are serious concerns about the claims about superior risk-adjusted performance which justify the high fees. The methodologies used to calculate the returns on private assets have been called into question.[17] Moreover, concerns about the claims of superior risk-adjusted returns are compounded by concerns about governance, illiquidity, and opacity of private assets.[18]

49. Overall, we doubt whether greater exposure to private assets would add value for pension savers but it would certainly require greater scrutiny by trustees and retail pension savers. Those who stand to gain are advisers, consultants, and asset managers who will have opportunities to generate higher fees.

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[13] DC consolidation and economies of scale: emerging evidence

[14] Government is even reserving powers to mandate schemes to invest a minimum proportion of scheme assets in private assets. Note that a key driver for this push to get schemes to invest in private assets is the Government's view that this will unlock private capital for UK physical and social infrastructure and, in turn, produce better returns for pension schemes. It may well channel more private capital into infrastructure, but the return expectations means that this will be a more costly way to fund that infrastructure. The return expectations will be paid for by households through higher bills and/or service charges. It would be interesting to know whether pension scheme members realise that their contributions could be used to extract value from social infrastructure. Moreover, even if the gross returns might be attractive on paper, once the high fees, charges extracted by the supply chain of asset managers, consultants, and advisers are accounted for the net returns may not be that favourable.

[15] The Productive Finance Working Group had 28 members. None were from civil society. (21) The almost total dominance of private finance lobbies in financial policy development | LinkedIn

[16] Regulatory Priorities: Pensions report

[17] See for example: The delusion of private equity IRRs

[18] Asset Owners Face Private Markets' Transparency Test | MSCI

50. More generally, it is important that pension scheme trustees and retail pension savers are not misled by claims by asset managers, consultants, and advisers about the potential for superior future investment performance to offset higher charges. Of course, investment returns do matter, and better performance can offset high charges. However, the value delivered by investment returns can only be recognised with hindsight. We cannot predict future superior performance based on past performance.
51. Yet, even though there is the obvious potential for investment performance claims to distort market behaviours, it is a matter for concern that TPR and FCA are indeed conflating costs and investment performance through the Value for Money (VFM) initiative. TPR/FCA intend to move towards a single 'better outcomes' measure based on net-of-costs investment performance.
52. As we set out in previous publications, the emphasis being placed on past investment performance in the VFM reforms[19] risks diverting trustees and pension savers' attention from the importance of costs. This will create opportunities for consultants and asset managers to justify pushing up costs by promoting more complex strategies and products supposedly offering the potential for superior risk-adjusted returns.
53. We think attention should not be diverted from the importance of costs. It is risky to allow charges (which can be controlled) to rise in the hope that these will be offset by better returns (which can't be controlled).
54. Driving down end-to-end supply chain charges in the pensions industry should be a priority for TPR and the FCA. But, the combination of the VFM reforms, the pressure to invest in high risk/ high cost assets, and weakening of the workplace pensions charge cap risks could actually undermine rather than enhance pension outcomes. This could reverse the real progress made in injecting efficiency into the private pensions market and bringing down charges.

The individualisation of risk within the UK pension system

55. We have seen a significant transfer of risk and responsibility for retirement provision due to the closure of defined benefit schemes and growth in defined contribution (DC) type schemes. The variability of investment returns in the UK pension system means that retirement outcomes can be something of a lottery. As the Commission points out, a one percent difference in annual rates of investment returns can make a 30% difference to pension outcomes at retirement. And, to reiterate, superior investment performance cannot be predicted.
56. Moreover, it is not just during the accumulation phase where we have seen the individualisation of risk; the pension 'freedom and choice' reforms means many savers risk running down their defined contribution wealth too quickly.
57. Note that this is an issue for all pension savers in DC type schemes, not just the priority groups highlighted above.
58. The pension system cannot be considered in isolation. The UK has a weak collective social security safety net ***and*** relatively low levels of private savings compared to major comparator countries.

[19] FCA/TPR Consultation CP26/1 The Value for Money Framework: Response to consultation, further consultation and discussion paper | The Financial Inclusion Centre

59. The sheer, unnecessary complexity of the UK pension system and individualisation of risk in the UK pension system means there is a very real need for good, objective financial advice. Yet, the market can only serve a limited proportion of the population - see below.

60. The individualisation of risk is not conducive to the goal of ensuring the optimal number of citizens can look forward to a decent, sustainable income in retirement. In addition to objective advice, more progress needs to be made on developing well regulated, well governed arrangements for collectively sharing risk. TPR and FCA should prioritise working with stakeholders to progress the development of collective risk sharing accumulation approaches and supervising default decumulation options.

Access to independent advice and information

61. There is a need for enhanced access to independent, objective financial advice and information to help citizens make effective decisions about pensions. The commercial financial advice market is unable to meet the needs of citizens with low or modest assets. This means there is a significant 'advice gap'.

62. Government and the FCA are trying to partially address this advice gap through the introduction of 'targeted support' and 'simplified advice'. While targeted support and simplified advice are primarily focused on FCA regulated activities, these reforms will have an impact on members and trustees of employers schemes, and the guided retirement duty. However, the FCA reforms would weaken consumer protection and would not close the 'advice gap' in a safe way.

63. Targeted support and simplified advice will allow financial firms to, in effect, digitally cold call consumers to sell them higher risk, higher cost investment products but with consumer rights to redress curtailed in the event of suboptimal outcomes.[20] The FCA could have required regulated firms to provide better support to customers at risk of making poor pension decisions (eg. drawing down too much money from their pension pot) through more robust application of the regulator's flagship Consumer Duty initiative. But it chose not to do this instead preferring to weaken consumer protection to incentivise the market to do so.

64. Even with the implementation of these deregulatory measures, the issue of how to provide financial advice to those consumers the market cannot serve or who struggle to pay for individual financial advice still needs to be addressed. The market (whether financial advisers and/or private pension providers) are unlikely to be interested in the financially vulnerable groups highlighted above. Again, this is not a criticism of the market, rather a reflection of commercial realities.

65. An alternative to market provision is needed. The Money and Pensions Service (MaPS) provides very helpful and comprehensive information and guidance to financial consumers via its MoneyHelper service. But, many consumers need more than

[20] (4) 'Targeted support' - FCA is designing the market to suit the interests of firms it regulates, not the consumers it is meant to protect | LinkedIn, ADVICE-GUIDANCE-CP27-17-FINANCIAL-INCLUSION-AND-MARKETS-CENTRE-SUBMISSION-290825.pdf, Financial Conduct Authority (FCA) Consultation Paper CP26/10 Simplifying the Pensions & Investment Advice Rules | The Financial Inclusion Centre

information and guidance. They need clear advice and recommendations on what is the best course of action to take on key financial matters.

66. We argue the role of MaPS should be expanded to oversee the operation of a National Financial Advice Service (NFAS)[21] to provide and enable access to objective, free financial advice on pensions and savings to complement the commercial financial advice market. We urge DWP, HMT, TPR, FCA, and MaPS to develop such a financial advice service.

Key regulatory matters

67. Robust regulation and governance of the private pensions sector (employer and personal) will be needed to maintain consumer trust and confidence in the pension system and build a sustainable, efficient, safe private pension system. Again, this affects all pension savers, not just the priority groups highlighted above.

68. But, as mentioned above, we take the view that a number of legislative and regulatory initiatives - targeted support, the VFM agenda, weakening of the charge cap, and the drive to get pension savers to invest more in private assets - will be actually detrimental to the long term interests of pension savers. Unfortunately, these initiatives are unlikely to be reversed now.

69. There are a number of other key regulatory issues which need to be addressed to manage risks in the pension system. We hope that progress can still be made on these. The issues include: standards of governance, conduct of business and 'consumer'[22] protection regulation, and transparency in the pensions system; prudential risks in the system as a result of weak regulation of life insurers that manage pension assets and the emergence of AI; and the fragmentation inherent in the current 'three peaks' regulatory system – The Pensions Regulator (TPR), Financial Conduct Authority (FCA), and Prudential Regulation Authority (PRA).[23] The regulation of environment-related risks is dealt with separately, below.

70. We remain concerned about the weak governance standards, inherent conflicts of interest, concentration of power, and weak member engagement and representation in the contract based pension market and the master trust sector - today nine in 10 trust-based DC pensions are in master trusts.[24] Moreover, as the Government points out, at present, there is no specific regulatory regime regulating the services provided on pension scheme selection advice or investment consultancy.[25]

71. With regards to prudential regulation of life insurers, our specific concern relates to the Matching Adjustment provisions in Solvency II/UK regime which allows insurers to create artificial capital which inflates their balance sheet strength. This calls into question the ability of certain insurers to meet long term return expectations during the pension accumulation phase. Solvency II/UK has also been weakened, at the behest of life insurers, to incentivise more investment in private assets including infrastructure.

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[21] Modelled on the previous government body The Pensions Advisory Service (TPAS).

[22] Consumer in this case covers employers scheme members and personal pension plan holders.

[23] Plus the other parts of the regulatory system – the Ombudsmen schemes and FSCS/ PPF

[24] Oversight of largest DC schemes evolves with a sharper focus on member outcomes | The Pensions Regulator

[25] Pensions Investment Review: Unlocking the UK pensions market for growth - GOV.UK Although, some firms are regulated by the FCA due to other activities which they carry out.

72. The growth in the pension transfer market, where DB promises are being transferred to poorly regulated and governed life insurers who manage pensions on behalf of millions of citizens, is deeply worrying.[26] This growth is further spurred as a result of the emergence of DB scheme surpluses.[27] There are competition concerns, too, given the dominance of a small number of buy-out/in providers.[28]

73. We have called for a pause on further pension transfers until a full investigation into the risks associated with transfers and competition concerns can be fully addressed, and to examine whether the current regulatory approach adopted by TPR, FCA, and PRA is fit-for-purpose.

74. With regards to AI, it may well be that this could be a positive development for the pension system both in terms of enhancing scheme administration and communications with scheme members, and allowing FCA/ TPR to regulate the market more effectively. However, the rapid emergence and application of AI in the financial system is a significant cause for concern.[29] So far, concerns have primarily focused on the banking and financial system, but the pensions sector will obviously not be immune to the potential threats and will face similar challenges. The nature of AI risks warrants a much more precautionary and coordinated approach by financial policymakers and regulators than has been hitherto shown.

75. As mentioned, the current system of regulation is fragmented. Managing the various elements of private pension regulation - consumer protection, conduct of business regulation, prudential regulation, and management of systemic risks - is shared between TPR, FCA, Financial Ombudsman Service (FOS), The Pensions Ombudsman, Financial Services Compensation Scheme (FSCS), Pension Protection Fund (PPF), and PRA/ Bank of England.

76. The management of the prudential, conduct of business, and competition risks relating to pensions transfers straddle the work of TPR, FCA, and PRA (and arguably the Competition and Markets Authority).

77. Throughout the pensions supply chain, different aspects of market conduct are regulated by different regulators. Moreover, ordinary pension scheme trustees are treated as if they are 'sophisticated' investors by the regulatory system. Retail pension savers are covered by much more robust conduct of business regulation and consumer protection measures. The approach towards trustees is not appropriate given the scale of assets involved in and the number of individual scheme members who rely on occupational pension schemes, and the weak regulatory oversight of institutional pension consultants and advisers. The impact of a suboptimal recommendation by institutional pension consultants and advisers on asset allocation and choice of assets

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[26] Pension trustees facing a pincer movement (2) Post | LinkedIn
[27] Defined benefit pension scheme surpluses and insurance (2) Post | LinkedIn
[28] Our concerns are set out here: HM Treasury reform of Solvency II consultation | The Financial Inclusion Centre Pension transfers-time for action Post | LinkedIn, Pension trustees facing a pincer movement Post | LinkedIn
29 Current approach to AI in financial services risks serious harm to consumers and wider system - Committees - UK Parliament

can have a significant impact on the pension outcomes of large numbers of scheme members.

78. On the prudential/systemic risk side, the structural flaws in the regulatory system due to fragmentation were shown up during the crisis in pensions related to Liability Driven Investment (LDI) strategies.

79. We take the view that the regulatory architecture relating to pensions should be reorganised. We advocate for all matters relating to the prudential regulation of pension schemes be transferred to the PRA, with all conduct of business matters transferred to the FCA. This would allow TPR to concentrate on the critical role of ensuring schemes are run and administered effectively.

Pensions and the environment

80. The risk to the pension system created by environment change requires special attention. As the Second Pensions Commission highlights, climate change and biodiversity loss pose significant risks to investment portfolios, both in terms of physical risks and policy risks related to the green transition. It references analysis that concludes that under a high warming scenario, UK pension funds could experience a decline in investment returns between 20% and 30% per year by 2040.[30] This would have potentially stark impacts for retirement adequacy.

81. We do not think that the financial regulatory system takes seriously enough the potential impact of environmental change on pensions (and the wider financial system) and vice versa.[31] The financial regulatory system is not aligned with climate goals. This surely has to change.

82. Of course, the Government and regulators could try to incentivise the pensions, insurance, and investment industry to divest from climate-damaging activities and invest more in climate-supporting activities. But, the history of finance tells us that sanctions and deterrents are more effective at changing financial market behaviours. More robust, targeted regulations and sanctions can achieve the twin goals of deterring climate-damaging activities and encouraging climate-positive activities. That is, penalising climate-damaging investments makes climate-positive assets commercially attractive in comparison.

83. It should be remembered that UK financial institutions are prohibited, quite rightly, by law and regulation from enabling money laundering, enabling sanctions evasions, financing terrorism, insider dealing, and misselling to consumers. It is remarkable that financial institutions continue to be allowed to finance, at scale, economic activities that harm the environment, so contributing to *the* existential threat faced by the financial system including pensions.

84. Adopting a much more interventionist approach to aligning the behaviours of financial institutions, including pension schemes, with environmental goals should be a priority for TPR, FCA, and PRA. Greater transparency is essential. The emphasis should move from narrative-based disclosures which just allow financial institutions to obfuscate to

[30] The Second Pensions Commission - Pensions 2050: Evidence and Future Priorities - Interim Report

[31] Time for Action – Greening the Financial System | The Financial Inclusion Centre, The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre

requiring schemes to disclose underlying data on the emissions financed in portfolios and calculate ‘portfolio greenness ratios’.

85. ESG ratings providers are yet to be regulated but, to be fair, there are plans to do so. This regulation should be expedited.

The potential impact of AI on labour markets and pensions policy

86. We covered the potential impact of AI on the pensions system from a regulatory risk perspective above. But, while FIMC does not specialise in macro-economics or labour markets, it would be remiss of us not to mention the potential impact of AI on jobs and the workplace.

87. Pensions policy and labour markets are inextricably linked. Individual pension incomes in retirement come from a combination of state/ private provision and pay-as-you-go/prefunded models - see above. The combination very much depends on the nature of an individual’s employment history and prospects.

88. Very different scenarios for the impact of AI on labour markets have been envisaged. Some envisage significant long term improvements in productivity and living standards, which should be positive for enhancing retirement incomes. Others envisage potentially devastating or at least very disruptive, transitional impacts for the economy and certain sectors of the economy.

89. As mentioned, the current system of AE is based around an employer administering deductions from wages and contributions to a pension scheme. It works best for employees with permanent jobs and comparatively predictable and regular monthly earnings. If AI results in a reduction in the number of permanent jobs, a growth in ‘gig economy’ or part time jobs, or a rise in unemployment then this will clearly affect long term pensions policy.

90. We cannot say with certainty at this stage how AI will change the structure of the labour market. But, consideration will need to be given to future proofing pensions policy in some way against the potential impact of AI, including protecting employees who may be affected during any transitional period.

This marks the end of our submission.

Financial Inclusion and Markets Centre (FIMC)
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