Making automatic enrolment work

A review for the Department for Work and Pensions

Paul Johnson, Frontier Economics and Institute for Fiscal Studies
David Yeandle, Engineering Employers' Federation
Adrian Boulding, Legal & General

October 2010

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Executive Summary

Current policy is that new duties will be staged in between 2012 and 2016, requiring all employers to designate a pension scheme into which all of their employees, aged between 22 and state pension age, should be automatically enrolled, so long as they are earning above an annual earnings threshold (the Pensions Act 2008 sets this threshold at £5,035, equivalent to £5,732 in today's prices). Upon automatic enrolment, a minimum of eight per cent of earnings within a band would be contributed to the pension, with at least three per cent coming from the employer. This policy is designed to maximise private pension saving by individuals without imposing compulsion. The right to opt out of saving will remain, but the expectation is that inertia will lead many people to remain automatically enrolled, just as inertia today appears to be an important reason for a lack of pension saving by many people.

In this review, we are not asking whether automatic enrolment, as such, is desirable. Rather, we are looking at its scope and whether a new national pension scheme (NEST) needs to be put in place for it to work. Our work, and our conclusions, fell into four broad categories:

- First, is there a case for excluding a substantial additional tranche of workers from automatic enrolment, for example those earning below a particular threshold or those above a certain age?
- Second, is there a case for excluding any group of employers, in particular the very smallest employers, from the additional responsibilities implied by the policy?
- Third, would any changes to the proposed regulations, implementation and details surrounding automatic enrolment enhance the policy?
- Fourth, under what circumstances is NEST necessary for the successful implementation of automatic enrolment and are there changes to the rules surrounding NEST which would be helpful?

We have, in addition, inevitably had to engage with many broader elements of the pensions' landscape. There are one or two areas, which are beyond the scope of this review, but which are important to the operation and success of an automatic enrolment policy, and where we recommend further work by Government.

Scope: individuals

The purpose of the automatic enrolment policy is to increase the numbers of people saving for their pension by ensuring that inaction on their part will lead to pension saving occurring, just as inaction at present leads to no saving. The risk with such a policy is that inertia will lead to some people saving when they might have been better off not saving.

To understand this risk, it is important to go back to the basic question of why saving for retirement is generally in people's best interest. The answer lies in the value of income, or consumption smoothing. Our lifetime welfare will be improved if we can shift income from periods when we have lots of it – hopefully, when we are in work – to periods, like retirement, when we may not. The premise behind the automatic enrolment policy is that many millions of people are saving so little that they will in fact be much worse off in retirement than during their working lives.

If there are people who are not much better off in work than they would expect to be in retirement, then automatic enrolment risks leading them to save inappropriately. They could end up taking income from a time when they really need it, when they are working, paying a mortgage and bringing up children, to a time when they actually need it less. The benefits that the State pays in retirement may leave some people as well off in retirement as they were in working life.

Potentially, this is a serious issue. For those on low earnings during working life, State benefits can replace most of income in work. Somebody earning £10,000 a year over a working life would, net of tax, receive almost as much in benefits at retirement as they received in work. It looks like it would make little sense for such a person to save for retirement. After that net replacement rates fall quite swiftly with earnings. For someone earning £15,000 a year during working life, the State will provide a net replacement rate in retirement of somewhat over 70 per cent, rather than 100 per cent or so enjoyed by the lower, £10,000 a year, earner.

This looks like it provides a strong prima facie case for a significantly higher threshold for automatic enrolment, one in the £10,000 – 15,000 a year range, than is currently envisaged.

There are several considerations which militate against such a conclusion. These include the existence of working tax credits, which provide a big incentive for many low earners to save in pensions, and the fact that earnings fluctuate such that most low earners go on to earn more at some point and only through saving year on year can they accumulate a pot of reasonable value. But much the most important consideration is the fact that in the real world, for most people, it makes little sense to look at individual replacement rates like those quoted. Most of us live in households with others. And most very low earners are women living with men who earn rather more. It may well be desirable for them to be accumulating a pension pot of their own.

We believe this question of whether automatic enrolment really will lead to welfare gains through consumption smoothing is at the heart of deciding on an earnings threshold for automatic enrolment. But others have generally focussed on the question of whether, in the face of means-tested benefits in retirement, it 'pays to save'. They are effectively asking 'why should people bother to save, if much of the benefit they get from saving will be lost from withdrawal of means-tested benefits?' This may be a particularly serious issue for those likely to be in receipt of Housing Benefit in retirement.

We consider different ways of looking at the question of whether it is worthwhile for someone to save. On one measure, the number of people who are automatically enrolled who at least get back their own contributions (in real terms), it is worthwhile for almost everyone. But this treats employer contributions as 'free money'. If the incidence of these contributions is on the employee, as would happen if employers reduce pay over time, then relatively large numbers, particularly of older cohorts, may not get back all their contributions. The reality is likely to sit somewhere in between.

In any case, it is hard to identify in advance who will be dependent on means-tested benefits and its certainly not as straightforward or as simple as applying a different earnings threshold. Once again, the inconvenient habit of the population of living in family units makes this difficult. And, in our view, it would be wrong to suggest to whole classes of people that they should not be saving because they might in the future be eligible for means-tested benefits. Wrong in the sense that both future policy and their own future incomes are unpredictable. And wrong in the sense that means-tested benefits are intended to compensate those unable to look after themselves, not those who actively choose not to.

In the end, unless we move the annual earnings threshold to £15,000 or more we cannot guarantee that everybody who is automatically enrolled will be better off as a result. And moving the threshold up to anything like this level will mean not automatically enrolling many millions who would benefit. Our judgment is that the detriment of any very substantial increase in the threshold would not justify the possible benefits.

However, there is one important change that we do recommend. The currently proposed threshold is very low, well below the current income tax threshold. In addition, contributions are due from the first pound earned above that threshold. This means that many people on very low earnings will build up very small pots indeed, potentially damaging the credibility of the reforms. We propose that people should only be automatically enrolled once they reach the income tax threshold (which the Government has announced will be increased to £7,475 in 2011, equivalent to £7,336 in today's prices), but that contributions should be on earnings in excess of the National Insurance earnings threshold (£5,715 in today's prices). This will avoid automatically enrolling those not earning enough to pay income tax, will ensure that the very tiny levels of pension contribution possible under the current proposals are avoided, and will ensure that many who would benefit from automatic enrolment are not excluded by a higher threshold. Our intention is that workers who earn between these two thresholds would be able to opt in and receive an employer contribution if they choose to do so.

We reached a similar conclusion on whether to change the upper age threshold for automatic enrolment. While it is true that some older workers face potentially lower returns from pension saving, there are many that could see real benefits from saving – for example, because they can build on earlier savings, because they will be able to 'trivially commute' their savings pot into a lump sum at retirement or because they intend to continue to work and save beyond the State Pension age. Our judgement here was the detriment of potentially excluding such older workers from saving outweighed any potential benefits of a lower age threshold.

Scope: employers

Employers have a central role to play in automatic enrolment policy. Every employer has to designate a pension scheme and then automatically enrol all their qualifying workers. The vast majority of employers are very small. Two thirds, that is around 800,000 employers, have fewer than five employees. Very few of these have any experience of any kind with pension provision. Current policy will impose a range of obligations on employers and effectively give them a role in pension policy which they have never previously had.

In addition, the inclusion of many hundreds of thousands of very small employers will present a major logistical, regulatory and enforcement challenge. Over 45 per cent of the cost the employer compliance regime is driven by the need to include micro employers. The overall administrative cost, of compliance and regulation, will be much higher, per employee enrolled, for the smallest employers than for larger ones.

Under these circumstances, we have looked very carefully at the question of whether there is a case for excluding micro employers from the scope of the policy. In the end, we have come down against such a recommendation for three main reasons:

- To do so would exclude 1.2 million employees from automatic enrolment.
- There would be substantial practical problems in enforcing boundaries. Identifying those employers with five employees at any one time is almost certainly beyond the capacity of current systems. In addition, incentives to hide or distort the number of employees could be considerable.
- A significant disincentive to business growth would be created. The pension costs alone of moving from four employees to five could come to more than £1,500. In addition, some competitive distortions might be created between employers either side of the size cut off.

We could not have come to this conclusion had we not been convinced that NEST will provide a pension scheme that will be appropriate to most small employers, and one which will be very easy for them to use. We recommend that, in communicating with these employers, the Pensions Regulator should flag up in the strongest terms possible that the design of NEST specifically takes account of their needs. We believe in addition that there needs to be a well structured and concerted communications exercise to ensure that as many small employers as possible know and understand what is expected of them.

Ideally, some way should also be found to assure smaller employers that they will not be held liable for their scheme choice should something subsequently go wrong. We recommend that DWP look to provide maximum possible comfort to employers in these circumstances, particularly if they opt for NEST or a stakeholder scheme to fulfil their new duties.

Regulatory changes

There are many detailed regulations associated with the introduction of the automatic enrolment policy. We have considered them all with an eye to the costs and benefits associated with them, including the effects on smaller employers. We are proposing two major changes.

First, we believe there is a strong case for giving employers the opportunity to have a waiting period of up to three months. There was virtually unanimous support for a change of this kind amongst the employers and employer representatives we spoke to. This would allow employers to automatically enrol their employees at any point in the first three months of their employment (although workers who wish to opt in and receive an employer contribution in this period would be able to do so). This would have some effect on overall levels of savings and some people who move jobs very frequently might lose out. But relative to the current proposals, which would involve automatic enrolment on the first day of employment, we believe that, from the employer's point of view, this would have several advantages.

- It would avoid automatically enrolling the large numbers of workers who leave very quickly after starting employment, including many seasonal workers. Hence, the costs of administering many very small pots would be avoided.
- It would allow employers flexibility to align enrolment dates with their own payroll and other systems.
- It would allow workers more opportunity to decide whether they want to opt out, allowing them to respond quickly and possibly reducing the number of refunds and the number of employees with just one month's worth of contributions.
- It would go some small way to closing the gap in treatment between contract based pension schemes and trust based schemes, with the latter offering refunds of contributions if the employee leaves within two years.

Second, we propose a much simplified certification process. Automatic enrolment requires minimum contributions based on a very particular definition of pay, total pay between a floor and a ceiling. Most existing pension schemes involve contributions defined as a percentage of all basic pay (not above some floor). Employers who run good schemes at present want certainty over whether contributions based on these definitions are enough to meet the legislated amounts. If they have to change their scheme rules to achieve this, we believe there is a real risk that the revised rules may be somewhat less generous overall. So we are very keen that a certification process is as simple as possible. A process we think would work would ensure that any scheme which met one of the following criteria could be certified as meeting the requirements:

- a minimum nine per cent contribution of pensionable pay (including a four per cent employer contribution) or
- a minimum eight per cent contribution of pensionable pay (with a three per cent employer contribution) provided pensionable pay constitutes at least 85 per cent of the total pay bill or

- a minimum seven per cent contribution of pensionable pay (three per cent employer contribution), provided that the total pay bill is pensionable

We also propose some other more minor changes:

- Allowing the initial tranches of employers who are to be 'staged' into automatic enrolment in October and November 2012 the flexibility to act as early as July 2012 if they want.
- Allowing employers three months flexibility around their scheduled re-enrolment date.

NEST

Automatic enrolment requires that all employers are able to find a pension scheme into which they can enrol their employees. Providers are currently unable to profitably service many employers, particularly small ones. Whilst we would be naturally cautious of recommending such a major intervention into the market, with a Government loan, as NEST, we see no alternative if automatic enrolment is to be introduced at anything like the currently envisaged scope on anything like the currently envisaged timescale.

Whilst some of those we consulted felt that the market might eventually design ways of providing pensions profitably to small employers and those with low earnings, none was confident this could be done in the short term. Many were sceptical it would even be possible over a longer timescale. Both our discussions with senior industry figures and modelling carried out at DWP suggest to us that only with a dramatic reduction of scope could automatic enrolment proceed without NEST. Whilst it is hard to be precise, we would only be confident that NEST was not needed were employers with fewer than 20 employees and employees earning less than £14,000 a year excluded from scope.

Two particular policy variables also need to be considered in the context of NEST. The first is the current limit on contributions, set at £3,600 a year in 2005/6 terms (equivalent to £4,300 today). This limit has been imposed in the interests of ensuring that NEST remains focussed on its target market, those employers and individuals the pensions market currently finds too difficult to serve, and does not compete unfairly with the existing pension industry. We have two concerns about this limit. First, it has created a great deal of complexity and cost for the set up of NEST. Second, and in the long term more importantly, we are concerned that it will send the wrong message about what constitutes a reasonable ceiling on the pension saving that people need to do.

Given that we do understand industry concerns about possible competition as automatic enrolment is introduced and in that period it is important that NEST does continue to focus on its core constituency, we do not recommend any change to the cap in the short run. But we do recommend that it be removed once the staging in of employers is complete, and that Government legislate for this at an early stage.

The second issue relates to the possibility of NEST receiving transfers from other schemes – these are not currently intended to be allowed. In fact, this is part of a wider issue around transfers to which we now turn.

Wider changes

In the course of this review, we have had to consider how automatic enrolment fits into wider pension policy. We have already touched on the importance of means-tested benefits in determining the value of savings. We have also mentioned two other issues: the question of transfers between employer sponsored pension schemes and the different regulatory frameworks surrounding trust-based and contract-based pension schemes. These are both issues which we believe are crucial to the development and success of automatic enrolment and both issues which need urgent attention from Government.

Many people move between employers many times in their working lives, about 11 times on average. If they move between employers with different pensions schemes, they could easily end up with 11 or more different pension pots on retirement. This is difficult for individuals to deal with and expensive and inefficient for pension providers. But regulation makes moving pensions between one scheme and another very difficult, and few people do so. We believe that for the reforms to be truly effective it will need to be straightforward, indeed the norm, for people to move their pension pot with them as they move employer. We believe that Government and regulators need to review this issue as a matter of some urgency. It is in this context that we believe that NEST should be able to receive transfers in and pay transfers out, but only once automatic enrolment is established and the more general issue of pension transfers has been addressed.

Second, there is the issue of the difference between contract-based and trust-based pension schemes, which are regulated differently. That may not have mattered overly much when pension provision was entirely voluntary. But, now that it will be compulsory for employers to designate a scheme, the different regulation may drive behaviour – there may be regulatory arbitrage. The most serious issue would appear to be around the difference in treatment of people who leave employment early, with trust-based schemes enabling leavers in the first two years to have their contributions refunded, while contract-based schemes do not. In addition, those who stay a little longer and build a pot below £2,000 receive favourable commutation terms in a trust-based scheme. These differences could create a considerable incentive for employers to set up trust-based schemes and, indeed, we were told that many employers are exploring such arrangements for just this reason. How to resolve this is beyond our scope, but it does need to be resolved and Government should review this as a matter of some urgency.

We also recommend that Government continue with work to review whether the existing regulatory regime for the provision of defined contribution workplace pensions remains appropriate in the post automatic enrolment world.

Finally, it is important to remember what a big policy innovation automatic enrolment is. There is, inevitably, a great deal of uncertainty about its actual impact and how individuals and employers will respond. We take this uncertainty as read throughout this report. Given the novelty and importance of the policy, and the associated uncertainty, we think it particularly important that Government have in place a comprehensive programme of monitoring and evaluation.

Summary of Recommendations

- **The earnings threshold at which an individual is automatically enrolled into a workplace pension is increased and aligned with the income tax personal allowance and the threshold at which pension contributions become payable is aligned with the National Insurance primary threshold. Workers can opt in to saving and receive an employer contribution if they earn between these two thresholds.**
- **There should be no changes to age thresholds.**
- **The automatic enrolment duties should apply to all employers regardless of size, as now.**
- **Communications to micro employers from the Pensions Regulator should flag as strongly as possible that the design of NEST specifically takes account of their needs, and should support easy access to NEST.**
- **DWP should look to provide maximum possible comfort to employers that they will not be held liable for their scheme choice, particularly if they opt for NEST or a stakeholder scheme to fulfil their new duties.**
- **There should be a simpler system by which employers can certify that their defined contribution pension scheme meets the required contribution levels.**

- **There should be an optional 'waiting period' of up to three months before an employee needs to be automatically enrolled into a workplace pension. Workers can, however, opt in during the waiting period.**
- **The largest employers, who are scheduled to be brought into the reforms in October and November 2012 should be allowed to automatically enrol ahead of the planned start date of October 2012, and as early as July 2012, if they wish to do so.**
- **Employers should be given flexibility around the date they re-enrol employees who have previously opted out by allowing a six month window for this activity to take place.**
- **NEST should go ahead as planned to support successful implementation of automatic enrolment.**
- **Legislation should make it clear that NEST's 'contribution cap' will be removed in 2017.**
- **Government and regulators should review as a matter of some urgency how to ensure that it is more straightforward for people to move their pension pot with them as they move employer, so that by the time of the 2017 review the more general issue of pension transfers has been addressed and NEST is able to receive transers in and pay transfers out.**
- **Government should review as a matter of some urgency the scope for regulatory arbitrage between the trust and contract based regulatory environments.**
- **Government should continue with work to review whether the existing regulatory regime for the provision of defined contribution workplace pensions remains appropriate in the post automatic enrolment world.**
- **Government should ensure there are effective communications to individuals, employers (and especially smaller employers) and the pension industry in the lead up to and during the implementation of the reforms.**

Background to the review 1

Summary

Automatic enrolment into a qualifying workplace pension was one of the key recommendations of the Pensions Commission, which reported in October 2004 and November 2005, in response to findings that people are living longer and not saving enough to give them the income in retirement that they would like. DWP estimates that about seven million people are not saving enough for retirement. Evidence from both UK and international research shows that automatic enrolment is an effective means of achieving high workplace pension scheme take up. The Pensions Commission also highlighted a supply gap in the current market and recommended that a low-cost default scheme be introduced alongside automatic enrolment.

Since the Pensions Commission reported, there have been a variety of changes to the context of UK pensions. Estimates of projected future life expectancy continue to increase, the UK has suffered from the global economic downturn and rates of employee membership of employer sponsored private pensions schemes have continued to decrease.

Since 2006, DWP has worked to develop the detail of automatic enrolment policy, based largely on the recommendations of the Pensions Commission. The key difference between the Pensions Commission recommendations and the DWP proposal is that workers can be enrolled into any qualifying pension scheme, of which NEST is one option, whereas the Pensions Commission proposed a default scheme.

The review has been asked to consider the proposed scope for automatic enrolment and the policy of establishing NEST to serve the automatically enrolled population. We have revisited the current policy setting and considered alternative options, assessing their impact on levels of pension saving, employer and provider burdens, the deliverability of the programme, exchequer costs and value for money. In so doing, we have met with a wide range of individuals and organisations, and received 73 formal responses to our call for evidence.

1.1 Introduction

This report sets out the findings of our review of how to support the introduction of automatic enrolment. This introductory chapter:

- Outlines the findings and conclusions of the Pensions Commission, on whose work the policy of automatic enrolment is based.
- Summarises the main changes since the Pensions Commission report in the policy and economic environment relevant to the automatic enrolment policy.
- Describes the automatic enrolment policy as it stands at the time of the review.
- Sets out the terms of reference and the scope of the review.

1.2 The Pensions Commission

The Pensions Commission was set up in 2002 to assess how the UK pension system was developing over time and to consider whether there was a need to move away from a purely voluntary approach to pension saving. In their first report of October 2004[1], the Pensions Commission found that:

- People are living longer – the proportion of people aged 65 or over is rising rapidly and will continue to do so.
- Millions of people are not saving enough to deliver the income in retirement they would like.
- The state pension system was unfair, particularly to women and carers.
- The complexity of the pension system prevents people from making informed decisions about whether and how to save for their retirement, often leading to them not saving at all.

They considered three main solutions to this: revitalising the system of voluntary saving; making significant changes to the state pension system; and increasing levels of compulsory private pension saving.

The Pensions Commission concluded that the challenge cannot be solved by changes to the state system alone and that it would require a combination of state and private saving to deliver an adequate income in retirement. They also concluded that incremental increases in voluntary saving alone would not be sufficient, whilst compulsion risks forcing some people into saving more than they need to, as well as denying them the ability to choose to save in different forms. They recommended instead that the State should strongly encourage people to save in private pension provision, whilst also providing a platform on which to build this saving. They felt that this solution would need to be supported by a somewhat more generous state pension system, with reduced means testing, simplified to be more understandable, and with an increased state pension age.

1 Pensions: Challenges and Choices, The First Report of the Pensions Commission, 2004.

The Pensions Commission settled on a replacement rate – a measure of income in retirement as a proportion of income in work – of 45 per cent as a minimum target for median earners. They calculated that, to reach this level, a median earner would need to save around eight per cent of earnings for around 40 years.

To achieve this objective, the Pensions Commission recommended that government introduce automatic enrolment of workers into private pension saving, with minimum contributions from individuals and employers totalling eight per cent on a band of earnings.

In considering how this could be achieved, the Pensions Commission concluded that the pensions market would not be able to meet the mass demand for pensions created by automatic enrolment, in particular for low-to-moderate earners, and so they also called for the establishment of a National Pensions Saving Scheme, a low-cost default scheme into which individuals would be automatically enrolled.

These recommendations were broadly accepted by the Government of the time and commended a widespread political consensus.

1.2.1 Automatic enrolment

We have not been asked to review the question of whether automatic enrolment is an appropriate policy. There is a remarkable degree of consensus around it as an idea and the Government remains committed to it.

This consensus and commitment reflects convincing evidence that there is very substantial undersaving for retirement[2] resulting from:

- A limited understanding by many people of pensions and the benefits of saving for retirement.
- A tendency to procrastinate and not get around to saving, even where the need to save is recognised.
- Inertia and a tendency for people to accept the situation regarding saving that requires the least decision-making: for example, people who are not saving often stay not saving, while people who start saving often continue to do so.
- Difficulty in accessing pension provision, in particular for people on lower earnings or working for smaller employers.

Automatic enrolment is designed to tackle these challenges, harnessing the power of inertia to bring individuals into pension saving and keep them there. There is a growing body of evidence from both UK and international research showing that automatic enrolment is an effective means of obtaining high pension scheme take up, particularly where participation rates are low. Examples include:

2 DWP estimate 7 million people are not saving enough. Department for Work and Pensions modelling using data from the English Longitudinal Study of Aging.

- UK survey evidence from the Employers' Pension Provision Survey 2005 showed that, within private firms with at least 20 employees, the mean average for pension scheme membership (across all scheme types) was 60 per cent for those using automatic enrolment, compared with 41 per cent for those operating traditional opt in methods[3]. The median was 77 per cent compared with 29 per cent.
- An in-depth study of four UK firms offering stakeholder pension schemes showed that the introduction of automatic enrolment, moving from traditional opt-in, was associated with increased scheme participation rates.[4]
- Evidence from US case studies consistently shows a rise in 401(k) scheme membership following a switch from traditional opt in methods to automatic enrolment, from around 20-40 per cent to around 90 per cent membership amongst new employees three months after they were hired.[5]
- American research into 401(k) schemes showed that automatic enrolment had the largest effect among people with low incomes, minority ethnic groups and women.[6]
- The use of automatic enrolment in New Zealand's Kiwisaver has been effective, with consistent opt-out rates of around 35 per cent.[7]

1.2.2 The case for a National Pension Saving Scheme

Automatic enrolment is intended to increase the demand for pension saving by harnessing inertia, but this needs individuals to be able to access pension provision. The Pensions Commission highlighted a supply gap in the current pensions market. Their research indicated that it is not profitable for the pensions industry to serve many such lower earners, particularly those who work for smaller employers. This is an issue we discuss in some depth in Chapter 4.

Given this, the Pensions Commission concluded that competition alone would not be sufficient to deliver simple, low-cost, long-term saving products for those on or below average incomes and without existing access to a good workplace pension. For this reason, they recommended the introduction of a National Pension Savings Scheme (NPSS) with a universal service obligation.

In considering the Pensions Commission recommendations, the Government of the time examined two main proposals and a number of variations on these:

- NPSS model: in this model, proposed by the Pensions Commission, the scheme would be administered by a single organisation which would manage and service members' accounts and interface with fund managers. Competition under this model would be at the level of contract for supply, rather than for employers or individual members.

3 McKay, S, 2006, "Employers' Pension Provision Survey 2005", Department for Work and Pensions Research Report No 329.

4 Horack and Wood, 2005, "An evaluation of scheme joining techniques in workplace pension schemes with an employer contribution", Department for Work and Pensions Research Report No 292.

5 Choi, Laibson and Madrian, 2004, "Plan design and 401(k) savings outcomes", Boettner Centre for Pensions and Retirement Research Working Paper. Madrian and Shea, 2001, "The power of suggestion: Inertia in 401(k) participation and savings behaviour", The Quarterly Journal of Economics, vol.116, issue 4, pages 1149 - 1187.

6 Madrian and Shea, 2002, in Munnell and Sunden, 2004, "Coming up short: The challenge of 401(k) plans", The Brookings Institute.

7 "KiwiSaver Evaluation: Annual Report 1", 1 July 2007 – 30 June 2008, Evaluation Services, Inland Revenue, New Zealand, September 2008.

- Provider choice model: rather than a single organisation having oversight of the system, a limited number of branded pension providers would offer schemes and administer the accounts. Savers could choose their preferred provider, or be allocated to a default provider.

No option perfectly fulfilled all the evaluation criteria. Despite an initial cost to government and some concerns about its impact on competition, the NPSS model was assessed by DWP as preferable on four key criteria:

- Coverage: The more limited choice prescribed by the NPSS model was deemed to be more appropriate for consumers, and thus more likely to maximise participation. This was based on evidence showing that individuals commonly lack confidence with financial decision making and can be deterred by too much choice.
- Rate of return: Whilst set up and administration costs look broadly similar across the models, DWP analysis suggested that the provider choice model would be 20-25 per cent more expensive, due to the cost of marketing to individuals.
- Operational efficiency: The NPSS model was considered simpler for both employers and members, who only have to deal with one organisation.
- Risk: Regulators suggested that any approach delivered by branded providers was more likely to generate inappropriate business practices, since providers would have financial incentives to act against members' interests, for example, by competing aggressively to capture market share.

1.3 Developments since the Pensions Commission reported

Table 1.1 sets out developments to longevity, economic and fiscal conditions and state and private pensions since the Pensions Commission Report.

Table 1.1: Developments since the Pensions Commission Report

Longevity	People are continuing to live longer and estimates of projected future life expectancy have continued to rise in recent years. The latest projected life expectancy for someone reaching state pension age in 2010 is now 86.3 for men and 88.7 for women, 1.3 and 1.5 years more respectively than the projections based on 2004 data.[8]
Economic and fiscal conditions	The UK has suffered from the global economic downturn and the worst recession since records began in 1955. This has impacted on employment, productivity, investment returns and government finances. Having remained above 74 per cent since the turn of the century, the employment rate has now fallen to 72.3 per cent. Government borrowing and debt has increased. Public Sector Net Borrowing has been above 5 per cent for six consecutive years and is estimated to be 11 per cent in 2009/10. Meanwhile, Public Sector Net Debt has increased to an estimated 53.5 per cent of GDP in 2009/10 and is forecast to peak at 70.3 per cent in 2013/14.

8 2008-based principal population projections, Office for National Statistics; 2004-based principal population projections, Government Actuaries Department.

Table 1.1: Developments since the Pensions Commission Report (*continued*)

Annuity rates	Annuity rates are now at their lowest level for 20 years. For example, a 65 year old man with a pension pot of £100,000 could currently secure an RPI linked annuity rate of 4.25 per cent, compared with 4.82 per cent in July 2008 and 5.18 per cent in November 2005.[9]
Private pensions	In the private sector, employee membership of employer sponsored pension schemes fell from 42 per cent in 2005 to 37 per cent in 2009.[10] Active membership in open private sector defined-benefit schemes fell from 2.1m in 2005 to 1.1m in 2008. Active membership in private sector defined contribution schemes has remained broadly stable at around 1m.[11]
State pensions	State Pension Age will rise to 66 in 2026, 67 in 2036 and 68 in 2046. The Government is now consulting on whether to bring forward the date that it moves to 66. The number of qualifying years needed to get a full basic State Pension has been reduced to 30. Government has committed to restoring the link between the State Pension and earnings from April 2011, with a guarantee of a minimum increase of the greater of earnings, prices or 2.5 per cent. Government has committed to abolishing the Default Retirement Age from October 2011. In line with the Pensions Commission's recommendation, changes have been made to the Second State Pension so that it will begin to move to a flat rate from 2030.

1.4 The current policy

Since 2006, DWP has been working to develop the detail of the policy on automatic enrolment, put in place the legislative framework and prepare for implementing the proposals from October 2012. The key objective has been to maximise saving, so that more people are saving more for their retirement, and the policy has been designed to achieve this.

1.4.1 The scope of the policy

The proposals are largely based on the recommendations of the Pensions Commission with the following key elements:

- Employers are required to automatically enrol their workers into a pension scheme meeting minimum quality requirements.
- Minimum contributions of eight per cent on a band of earnings to be paid, of which at least three per cent must come from the employer.

The key difference between the Pensions Commission's recommendations and the DWP proposals is that the Pensions Commission envisaged the National Pension Saving Scheme as the default scheme into which most people would be enrolled. The DWP proposals are that workers can be enrolled into any scheme that meets certain quality standards. The NEST scheme (see Section 1.4.2) is just one scheme employers can use.

9 DWP data; based on a single-life, level annuity with no guarantee period, for a 65-year old male with a pension pot of £100,000.
10 Annual Survey of Hours and Earnings, United Kingdom 2005–2009, Office for National Statistics.
11 Occupational Pensions Scheme Survey, 2005–2008, Office for National Statistics.

The other key elements of the automatic enrolment proposals are set out in Table 1.2.

Table 1.2: The scope of automatic enrolment

Key feature	Rationale
Applies to all employers who employ one or more individuals under a contract of employment	To give all workers access regardless of who they work for
Workers must be at least 22 years old to be eligible	Aimed to align with National Minimum Wage age limits and so reduce burdens on employers Significant job-churn amongst under 22s, especially students
Workers must be below State Pension Age to be eligible	To align with State Pension Age
Workers must be working or ordinarily working in Great Britain	To capture all workers of any nationality working in GB and those that spend some time working outside GB
Applies to workers from their first day of employment	To ensure the widest possible increase in pension saving
Workers must earn at least £5,035 pa (2006/07 terms)	Aimed to align with the primary threshold for national insurance contributions and ensure that the individual is accruing a State Pension
Contributions are based on a band of earnings of between £5,035 and £33,540 (2006/07 terms)	To ensure costs of contributions are lower for lower earnings and limit those costs to employers of high earners To avoid a 'cliff-edge' arising once individuals earn enough to be automatically enrolled Aimed to align with the primary threshold and upper earnings limit for National Insurance contributions
Earnings are based on total pay, including overtime, commission and bonuses etc	To maximise increased pension saving To ensure individuals with significant elements of additional pay benefit equally
There is no minimum amount of contributions that must be paid	To avoid a 'cliff-edge' arising once individuals earn enough to be automatically enrolled
Although the self-employed or those not in work are not automatically enrolled, they may opt-in and pay voluntary contributions	To ensure these individuals can access pension saving, despite not having access to employer contributions
Workers aged between 16 and 22 and between State Pension Age and 75 can opt in and receive the employer contributions if they earn at least £5,035 (2006/07 levels)	To ensure broad access for people who want to save

Table 1.2: The scope of automatic enrolment (*continued*)	
Workers earning below the earnings threshold can opt in but will not receive the employer contributions	The reforms are not aimed at the very lowest earners for whom it may not pay to save
Individuals can stop pension saving at any time, but only after they have been enrolled	To best harness the 'inertia effect' and maximise the numbers in pension saving
Employers must re-enrol all workers who opt out, every three years	To ensure that individuals whose circumstances change over time don't remain not saving as a result of inertia
Additional Voluntary Contributions	To allow people to contribute more than the prescribed minimum if they wish

Under the current proposals, the new duties on employers will begin on 1 October 2012. They will initially apply to the largest employers only, with the remainder of employers staged over a four year period based on size.

Contributions will also be phased in, where an employer is using a defined contribution scheme, to ease the transition. During the four year period that employers are being staged in, minimum contributions must be at least two per cent of qualifying earnings, with at least one per cent from the employer. In October 2016, minimum contributions will rise to five per cent, with at least two per cent from the employer. From October 2017 onwards, minimum contributions must total at least eight per cent, with at least three per cent from the employer.

There will also be transitional arrangements for employers using defined benefit or hybrid schemes to meet their automatic enrolment duty, where certain conditions are met.

1.4.2 The NEST model

NEST will be a trust-based occupational pension scheme, managed by a corporate trustee, and will operate in broadly the same way as any other defined contribution occupational pension scheme i.e. under existing pension law and regulated by The Pensions Regulator.

As a result of its proposed purpose and scale, however, there are a number of differences:

- The scheme is established in secondary legislation and the corporate trustee is a non-departmental body sponsored by DWP, but operating at arms-length from Government.
- The scheme will have a public service obligation to accept any employer (and any qualifying worker) that wishes to use the scheme to fulfil their employer duties.
- All members of the scheme will remain members until they choose to access their savings at retirement.
- Members who have left the employment of a participating employer will be able to continue to make contributions irrespective of whether they are in employment or not.

- Self-employed individuals and single person directors will be able to join the scheme and make contributions.
- There will be an annual contribution limit of £3,600 (in 2005 earnings terms, equivalent to £4,271 today) to ensure NEST is focussed on its target market of those employers and individuals who the pension industry currently find it difficult to supply at a reasonable price.
- There will be a restriction on the transfer of accrued benefits into and out of the scheme, apart from in specific limited circumstances, again to keep it focused on its target market.
- A members' panel and an employers' panel will be established to allow the trustee to engage effectively with the diverse, large membership and employer population.

NEST is designed to be a low cost scheme and is expected to levy a charge of 0.3 per cent on members' funds under management to cover its ongoing cost of operation. This is in line with the Pensions Commission's findings on a deliverable aspiration for the scheme. Until the set-up costs of the scheme have been met, it will also make an additional charge of around two per cent of contributions.

These charges are designed to make NEST self-financing in the longer term. Income from these charges will take some time to build up, however, so the scheme will be funded in the short to medium term by a loan from Government. It is estimated that NEST will be self-financing by around 2030.

1.5 The review

The Terms of Reference for the review are included at Annex A.

They ask us to consider:

- Whether the proposed scope for automatic enrolment strikes an appropriate balance between the costs and benefits to both individuals and employers, or whether the underlying policy objective of increasing private pension saving, and balancing those costs and benefits, would be better delivered by a different scope for automatic enrolment.
- The availability and capacity of pension providers other than NEST to serve the potential automatically enrolled population.
- In the light of these conclusions, whether the policy of establishing NEST, as currently envisaged, is the most effective way to deliver future access to workplace pension saving and income security in retirement.

They suggest that, in looking for the right group to automatically enrol, we consider, amongst other options:

- The earnings threshold, above which automatic enrolment applies.
- The introduction of a de-minimis level for contributions before automatic enrolment applies.

- The age group to which automatic enrolment should apply.
- The size of firm to which automatic enrolment should apply.
- Whether employees should be automatically enrolled on the day they start work or some later date.

In reaching our conclusions, they ask us to have regard to the effectiveness of the proposals in:

- Tackling pensioner poverty as quickly as possible, including among women pensioners.
- Maximising voluntary private savings and the speed by which this objective can be achieved.
- Minimising the administrative burdens on employers and the impact on existing provision.
- Achieving an effective balance between the achievement of policy objectives, pace of implementation, value for money and risk.
- Maximising value for money for the exchequer.

We were asked to provide our conclusions to the Government by 30 September 2010.

1.5.1 The review team approach

The Pensions Commission's recommendations were intended to tackle the macro-economic problem of increasing longevity and insufficient saving for retirement. The current proposals for automatic enrolment were therefore largely designed in a 'top-down' fashion, focused on maximising the number of people contributing to a pension and filling the supply gap in the pensions market. It is also important to look at the proposals in a 'bottom-up' manner, considering the costs and benefits of including, for example, certain groups of individuals or employers within automatic enrolment. In this review we have looked to understand these costs and benefits in the context of the overall policy objectives. Meanwhile, in a difficult economic and fiscal climate, it is also important to consider the potential benefits compared with the impact on Government finances and assess the value for money of the proposals.

As well as listening to the views of those affected by the proposals and considering the costs, benefits and value for money, we have also been keen to consider the practical implications of our recommendations and the impact of these on the deliverability of the programme.

Importantly, our remit is to make proposals based on where we are today. We have not looked at whether different decisions could or should have been made in the past. Any costs that have already been realised are sunk. The question is, given where we are today, what should we do next?

Analysis

We have worked with analysts within the DWP to understand the detailed analysis underpinning the proposals for automatic enrolment, including:

- The groups of individuals affected by the proposals and their characteristics, including the dynamics of their employment status, their income and savings, and their interactions with state benefits.
- The likely payback that individuals will receive from pension saving, the factors affecting this and those groups who might be at risk of lower returns.
- The characteristics of employers affected, the likely costs to employers and the Pensions Regulator associated with automatic enrolment and the factors affecting these.
- Pension provider profitability, the factors affecting this and the ability of the pensions industry to meet the demand for pensions created by automatic enrolment in a range of scenarios.

This has enabled us to understand the rationale for the current proposals, where the costs of implementing the reforms lie and how the benefits of the additional pension savings generated are realised. In turn, this has allowed us to identify areas where alternative options might be considered, identify what these options should be and assess their impact.

In considering potential changes, we have assessed each option against the criteria proposed by our Terms of Reference: the impact on pensioner poverty, especially amongst women; on levels of pension saving; on employer and provider burdens; on the deliverability of the programme; on exchequer costs; and on value for money. We have also conducted cost-benefit analysis, comparing options and combinations of options, assessing their interaction and balancing their costs and benefits.

Consultation

In formulating our views on the existing proposals and potential options for change, we sought to consult with as many interested parties as possible. We met with a wide range of individuals and organisations, and held three seminars to discuss some specific themes with representatives of employee and consumer organisations, with employers and employer representative bodies, and with pension providers and members of pensions industry bodies. We also issued a call for evidence, with individuals and organisations invited to comment on any issues covered by the review's terms of reference. We received 73 formal responses to this call for evidence from a wide range of consumer, employee, employer and industry representatives. We would like to thank all individuals and organisations for their valuable input throughout the review period.

We have set out throughout the report the responses we received from the consultation activity and how these shaped our thinking and the options we considered. A list of those groups and individuals who responded formally to our call for evidence is at Annex B.

Delivery focus
One of the main areas of consensus on the automatic enrolment proposals, highlighted strongly in our consultation activity, is a desire that the introduction of automatic enrolment remains on current timescales and is not delayed, with the majority of stakeholders strongly in favour of retaining an October 2012 start to the implementation of the reforms. We regard this as particularly important in the light of the demographic situation and consider that any further delay to automatic enrolment could undermine the whole concept of the Pensions Commission's demographic argument. In addition, the current timescales are backed by a broad consensus and already have a strong delivery momentum. Discussions with Ministers have confirmed that they share a desire to make early progress in tackling the savings deficit.

Through our work on the review, and in particular when considering potential areas for change, we have therefore ensured that we consider issues of deliverability and timing. We have, for example, considered whether options would require changes to legislation and how they impact on the design of NEST processes, procurement exercises and the preparatory work and lead-in times required by employers and pension scheme providers. While this has not constrained our thinking, it has helped to inform our recommendations.

1.6 Report structure

In Chapter 2, we set out our analysis of individuals affected by the reforms, looking at the target groups for automatic enrolment and their characteristics, including their employment and income status and how these change over time. We have then looked at the likely impact on their incomes and welfare of pension saving, their likely payback from pension saving and the extent to which these are sensitive to variation in, for example, investment returns. These findings support the analysis of options in Chapters 5 to 7.

In Chapter 3, we set out our analysis of employers, looking at their characteristics, the costs they might incur as a result of automatic enrolment and the drivers of these. These findings also support the analysis of options in Chapters 5 to 7.

In Chapter 4, we set out our analysis of the pensions industry's ability to meet the demand created by automatic enrolment, looking at provider costs, profitability and the drivers behind these. We also consider potential alternatives to NEST for meeting the demand for pensions created by automatic enrolment, under the current proposals. Again, these findings support the analysis on options in Chapters 5 to 7.

In Chapter 5, we consider options for changing the target group for automatic enrolment, including, for example, changing the earnings threshold or excluding certain types of individuals or employers.

In Chapter 6, we consider options for changing the automatic enrolment process to reduce burdens on employers and pension providers.

In Chapter 7, we consider how changing the target group affects the supply side, looking at the impact of changes on profitability and the potential for the pensions industry to meet the demand for pensions created by automatic enrolment.

In Chapter 8, we work through the decision making around our final recommendations, and set out the impacts of our recommended package of changes.

Individuals 2

Summary

Pension saving can be valuable because it allows individuals to smooth consumption between periods when they are relatively well off (when they are working) to periods when they have less money (when they are retired). Despite this, the overall level of private pension saving is low and falling.

Automatic enrolment can be an effective technique for increasing overall participation in pension saving, and this should generate significant benefits in the form of greater consumption smoothing.

This chapter investigates the characteristics of individuals who will be automatically enrolled and the impacts for them of pension saving.

Analysis within the chapter suggests that:

- **People on low earnings throughout their lives probably do not need to save, but earnings are highly dynamic – there are relatively few people who have low earnings throughout their lives.**
- **More importantly, most of those on low earnings live in family units and have a working partner with significant earnings and are therefore likely to benefit from pension saving.**
- **Whether people will get a good return on saving depends on a range of factors, including how the employer contribution is accounted for, what returns look like, and what an individual's circumstances are in the future. These are very hard to predict in advance.**

- **Individuals who choose to opt out potentially do badly as they do not benefit from the employer contribution, and may also lose out from lower wage growth as employers seek to cope with the costs of automatic enrolment.**

This leads to the conclusion that there is no single earnings threshold that encourages saving amongst all those who need to save while neatly excluding those for whom the value of saving is more questionable. A relatively low earnings threshold has the benefit of encouraging those with a working partner, those who will go on earn more and those in receipt of tax credits to save. But it also encourages persistently low earners to save. A higher earnings threshold does the reverse of this.

2.1 Introduction

By saving, people smooth their consumption over their lifetime. Pension saving specifically involves deferring consumption from working life to retirement. If people save so little that their standard of living falls dramatically at retirement, they are likely to be able to increase their lifetime welfare by saving more. Yet, on many measures, private pension saving is inadequate and it is falling.

The reforms proposed by the Pensions Commission were designed to result in more people saving for their retirement and, thereby, benefiting from not seeing their living standards fall too far in retirement. There is, however, a risk that, for some people, pension saving may not be right. This chapter investigates the characteristics of individuals who will be automatically enrolled and the impacts for them of pension saving.

In particular, it focuses on the following:

- Whether some people really need to save. There may be a group of individuals who can currently expect a similar income in retirement to the income they have during their working life. Such individuals do not need to save. We believe this risk is higher amongst low earners, because the state provides a basic level of income in retirement, which might be close to the level of their income when they were working. Therefore we are keen to explore the earnings and employment dynamics of lower earners to understand whether the current earnings threshold (the level of earnings at which people are automatically enrolled) is right.

- Whether there are good incentives to save for all groups. Even where individuals need to save, they may have poor incentives to do so. Means-tested benefits in retirement are withdrawn as private pension income increases. This can make it less worthwhile to save. We want to understand this interaction and look at whether people see a sufficient benefit from saving.

This chapter will therefore look at:

- The characteristics of those with and without provision (Section 2.2).

- The value of pension saving and the role of automatic enrolment (Section 2.3).

- Whether everyone needs to save (Section 2.4).

- Whether there are always good incentives to save (Section 2.5).

- What it all means for the earnings level at which people should start to save (Section 2.6).
- Any consequences of changes to the State Pension system (Section 2.7).

2.2 Characteristics of those with and without workplace pension provision

We need to understand the characteristics of those who will be automatically enrolled under the reforms as they currently stand and to see how these characteristics compare with those of otherwise similar people who already have a pension scheme.

We therefore focus on individuals aged between 22 and State Pension age, with annual earnings of over £5,035 (in 2006/07 terms). The right hand column in Table 2.1 presents the characteristics of those individuals who are already in a "qualifying scheme" (with an employer contribution of at least three per cent).[12] The middle column sets out the characteristics of those individuals who are not in a qualifying scheme and therefore would be automatically enrolled. The analysis shows the following.

Around five to six million people are currently saving into a workplace pension scheme. These people:

- Have relatively high individual earnings, with a median gross salary of £30,000.
- Are more likely to be male (63 per cent) than female (37 per cent).
- Tend to be owner occupiers (just under 90 per cent) with a high level of household wealth (a median of just under £300,000).[13]
- Are highly likely to be in the White ethnic group (94 per cent).
- Work predominantly for large employers (with 69 per cent working for employers with 250 or more workers).

Between ten and 11 million people who would be eligible for automatic enrolment are not currently saving in a workplace pension scheme with an employer contribution of three per cent or more. Compared to the group with pension provision, these people:

- Have much lower salaries, with a median gross salary of £19,000 a year.
- Are more likely to be female (though in absolute terms, the majority, 59 per cent, are still male).
- Are less likely to be owner occupiers, with around one third of people renting, and have a lower level of household wealth (a median of around £130,000).
- Are more likely to be in a non-White ethnic group (over ten per cent).
- Tend to be more likely to work for smaller employers: 33 per cent work for an employer with 19 or fewer employees.

12 Where possible the analysis is split by those in a qualifying pension scheme (defined as having a three per cent employer contribution) and those without a qualifying pension scheme. Where data is used which doesn't include the employer contribution, a qualifying pension scheme is simply defined as being any pension scheme.

13 Household wealth is defined as the sum of net property wealth (value of property owned minus any mortgage debt), net financial wealth (formal and informal financial assets minus any financial liabilities), physical wealth (contents of main residence and any other property) and pension wealth (private pension wealth, including retained rights and pensions in payment).

Table 2.1: Individual characteristics of eligible employees (those between 22 and State Pension age with earnings above £5,035 in 2006/07 terms)

Characteristics	Eligible employees without a qualifying pension	Eligible employees with a qualifying pension
Number *million*	10 - 11	5 - 6
Median gross basic salary *£pa*	19,000	30,000
Earnings *percentage*		
Less than £7,336 *	6	2
£7,336 to £9,999	7	3
£10,000 to £14,999	20	7
£15,000 to £24,999	37	25
£25,000 to £32,999	15	21
£33,000 and over	15	43
Gender *percentage*		
Male	59	63
Female	41	37
Employer size *percentage*		
1-4	14	4
5-19	19	8
20-49	11	6
50-249	17	13
250+	39	69
Ethnicity *percentage*		
White	88	94
Mixed	1	1
Asian or Asian British		
Indian	3	2
Pakistani and Bangladeshi	2	*
Black or Black British	3	2
Chinese or other ethnic groups	3	1
Wealth *£*		
Median total household wealth	130,000	300,000
Housing *percentage*		
Owner occupiers	69	88
Social rented sector	13	4
Rented privately	18	8

Note: ***£7,336 is the 2011/12 income tax personal allowance in current earnings terms.

Source: Department for Work and Pensions volumes modelling, private sector only.
Annual Survey of Hours and Earnings, Great Britain 2009, Office for National Statistics.
Family Resources Survey, 2003-04, 2004-05 and 2005-06, Department for Work and Pensions.
Wealth and Assets Survey, Great Britain 2006-08, Office for National Statistics .

2.3 The value of pension saving and the role of automatic enrolment

2.3.1 The value of pension saving

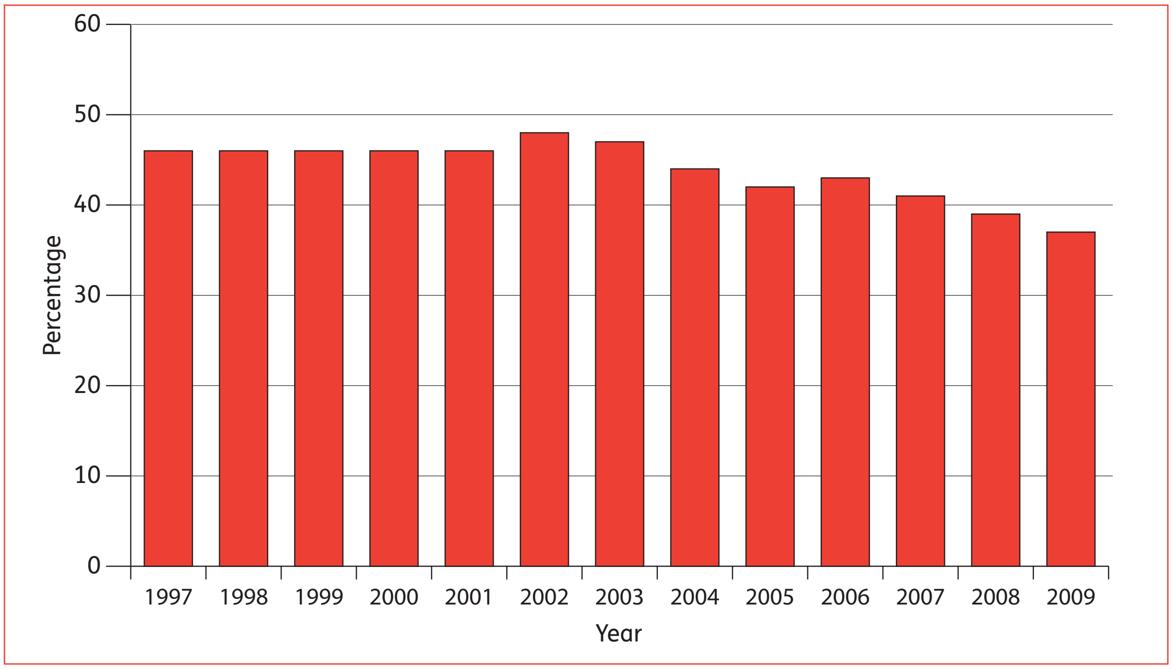
Private pension saving aims to provide individuals with an additional income in retirement over and above the income they will receive from the State via State Pensions and other benefits. The benefits of pension saving come from the individual moving income from a time when they have more income (working life) to a time when income is relatively lower (retirement). As a result, most people will increase their lifetime welfare by saving for their retirement. In economic terms, they are "consumption smoothing", ensuring that there is not a big drop in their spending power when they retire. Moving their consumption across time should make them better off because consumption is worth more to them when they are able to consume less.

In a world in which everyone was behaving rationally and in their own best interests, they would be choosing levels of pension saving to provide their desired or optimal level of smoothing. But the point of automatic enrolment is that, for behavioural reasons, there is convincing evidence that, left to their own devices, people do not make these long term decisions optimally. But not everyone is behaving irrationally by not saving. The concepts are important because they help us to understand who will benefit most from private pension saving. Those with significantly higher earnings in work than in retirement will gain, and those on low incomes in work will have less consumption to smooth.

2.3.2 Current trends in private pension saving

Despite the value of pension saving, the overall level of private pension saving in this country is low and falling. As Chart 2.1 demonstrates, there have been substantial falls in the level of private pension saving, even in the years since the work of the Pensions Commission. As we can see, employee membership of private sector workplace pension schemes fell from 46 per cent in 1997 to 37 per cent in 2009 (from 7.9 million in 1997 to 7.0 million in 2009). Since the number of private sector jobs increased over that period, the number of private sector jobs with no pension provision rose even more steeply. In 2009, over 11.5 million private sector jobs had no pension provision, an increase of 2.5 million since 1997. In addition, as a result of the swift decline in coverage of defined benefit pensions and the introduction of less generous defined contribution schemes, the amount being saved per person is also falling.

Chart 2.1: Percentage of private sector employee jobs with employer-sponsored pension provision



Source: Annual Survey of Hours and Earnings, United Kingdom 1997 – 2009, Office for National Statistics.

2.3.3 Impact of automatic enrolment

Automatic enrolment is designed to address this low and falling level of pension provision. Whilst many individuals are aware of the need to save into a pension, a range of factors, including inertia and myopia, prevent them from doing so[14]. Automatic enrolment "nudges" people into saving in a pension. It does this by creating a default position whereby the individual will save unless they take an active decision to opt out.

The ability to opt out is important when thinking about who we should be encouraging to save. We want to set eligibility criteria so that we encourage as many of the "right" people to save as possible, whilst bringing in the fewest number of people for whom the value of pension saving is more questionable. The ability to opt out is a key component in mitigating some of the risk associated with enrolling some people who may rationally decide that pension saving is not right for them.

Research has shown that automatic enrolment can be expected to increase the level of participation in pension schemes. The 401(k) experience in the United States shows there is a large difference in participation rates between employees hired before automatic enrolment (50 to 75 per cent) and after automatic enrolment (90 per cent or more)[15] .

In the UK, almost two in three (65 per cent) people eligible for automatic enrolment say they would stay in and save in a workplace pension if automatically enrolled tomorrow[16].

14 Clery E, McKay S, Phillips M and Robinson C, 2007, "Attitudes to pensions: the 2006 survey", DWP Research Report No 434.

15 Madrian C and Shea D, 2002, "Coming up short: the challenge of 401(k) plans", The Brookings Institute and Beshears J, James J, Choi D, Laibson B, Madrian C and Weller B, "Public Policy and Saving for Retirement: The "Autosave" Features of the Pension Protection Act of 2006". Available at: http://www.economics.harvard.edu/faculty/laibson/files/Better%20living%20080216.pdf.

16 Bourne T, Shaw A and Butt S, 2010, "Individual attitudes and likely reactions to the workplace pensions reforms 2009", DWP Research Report No 669.

Based on this research and a range of other evidence, DWP expect that, after accounting for people who opt out, automatic enrolment could result in:

- Five to nine million people newly saving or saving more in all forms of workplace pension scheme
- Three to four million people newly saving or saving more in existing forms of workplace pension scheme and
- Two to six million people saving in NEST, including some who were previously saving in existing forms of workplace pension scheme, and some who opt in.

Further detail of the methodology used to derive these figures is set out at Annex C, Chart C.1.1.

As a result of automatic enrolment and the associated higher levels of pension saving, the expectation is that society as a whole will feel substantially better off[17]. This is measured by a concept known as social welfare. According to the methodology set out in a DWP technical working paper[18], the impact of consumption smoothing might increase social welfare significantly[19]. This amount does not represent a financial transfer, but represents the value to individuals from transferring income from more affluent times to retirement[20]. And whilst there are obviously many judgements to be made in calculating these sorts of numbers, they do give a good sense that automatic enrolment could raise social welfare substantially.

2.4 Does everyone actually need to save?

Pension saving is valuable where individuals have more money in their working lives than they do in retirement. Where the reverse is true, and an individual has more money in retirement than in working life, the value of consumption smoothing disappears.

This section is designed to help us understand who should and should not be saving. It estimates the "replacement rates" (defined below) that individuals on stable earnings over their lifetime can expect to see. We then go on to look more closely at earnings dynamics and family make-up to help us understand the value of the replacement rate analysis.

2.4.1 Replacement rates

One of the key measures we have to help us understand who needs to save is the replacement rate. Replacement rates show annual income in retirement as a proportion of annual income in working life. So a replacement rate of 100 per cent shows that an individual has the same income in retirement as they did in working life. A replacement rate of 50 per cent shows that an individual has half the income in retirement that they had in working life.

17 Layard R, Mayraz G and Nickell S, 2006, "Marginal Utility of Income", considers these ideas in some depth and suggests that the assumptions used in our analysis are conservative with respect to the value of redistribution to individuals.

18 van de Coevering et al., 2006, "Estimating economic and social welfare impacts of pension reform", DWP Pensions Technical Working Paper. Available at: http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep562.pdf .

19 by around £40 billion to £55 billion for the period up to 2050 according to DWP estimates.

20 Recent developments in the field of welfare economics recommend an increase in the factor that is used to weight pension returns in the Department for Work and Pensions' Social Welfare model. The total impact of this change has not yet been estimated, though it is expected to significantly increase the overall value of the reforms while still being conservative in terms of the assumptions underpinning the analysis.

Target replacement rates

The Pensions Commission used replacement rates within their work, and suggested that the minimum gross replacement rate, based on research on individuals' views, should be at least 45 per cent, around two thirds of which would come from the State. But the Pensions Commission also noted that the median earner might want to save more to get up to a more typical 67 per cent gross replacement rate, and that lower earners might aim for gross replacement rates of 80 per cent or more[21].

Gross vs net replacement rates

Gross replacement rates are commonly used and simple to understand. But they are a poor indicator of the change in what someone has to live on, since an individual's gross income will be reduced by tax. And because pensioner tax allowances are more generous than working age tax allowances and pensioners do not pay National Insurance Contributions, gross replacement rates will over-state the change in living standards between work and retirement. As a result, we focus on measures of net replacement rates in this report. In fact, we might well want to take account of other differences in costs between working age and retirement. Ideally, one might want to subtract the costs of mortgages, children and costs associated with working from income during working life in order to get a fair comparison with income in retirement. We bear this in mind, but do not attempt to show the effects numerically.

Replacement rates by earnings and age

Table 2.2 shows what replacement rates look like for individuals at different income levels, depending on whether or not they save into a pension scheme following automatic enrolment. See C.1.2 in Annex C for a series of illustrative case studies which provide much more detail about the calculations underpinning the replacement rates, what the different sources of income are and the impact of varying real fund growth rates.

The most striking thing about this analysis is how high replacement rates are for some groups, even in the absence of any private pension saving. For those individuals with annual earnings of below £10,000 throughout their working life, we can see that the state system, through a combination of the State Pension and income-related benefits, provides the individual with a very high replacement rate. In many cases, the replacement rates are in excess of 100 per cent, making it hard to see how these individuals could be considered to need to save.

As we have discussed, even where replacement rates are below 100 per cent, there is a risk that automatic enrolment could result in over-saving. That is because people tend to have lower costs in retirement and therefore need less income in order to maintain their standard of living. Lower costs could come from no longer incurring work expenses (such as travel), having mortgage costs, or having dependent children.

This analysis raises significant questions about the validity of an annual earnings threshold of £5,035. Even at earnings substantially above this level, individuals see very high replacement rates from the State. Based on this analysis alone, we might easily argue that an earnings threshold of over £10,000 would be more appropriate to encourage the right individuals (those who actually need to save) to begin saving into a workplace pension.

21 Pensions: Challenges and Choices, The First Report of the Pensions Commission, 2004.

There are two key reasons to question such a conclusion. Firstly, earnings are not static. For many, earnings could change dramatically over their lifetime. For these people, saving for a pension whilst on relatively low income could be beneficial as it improves persistency of saving and increases income in retirement. Secondly, many individuals live in a family unit. It is the circumstances of the wider family that are more important in determining whether it is appropriate for a particular individual to save.

Table 2.2: Net replacement rates with and without default savings levels

		Age in first year of saving			
Annual earnings		**22**	**30**	**40**	**55**
£6,000	Gross weekly private pension (£)	1	1	0	0
	Final net weekly income (£)	181	180	176	170
	Net replacement rate without saving (%)	156	156	153	147
	Net replacement rate with saving (%)	156	156	153	147
	Improvement in net replacement rate from saving	0	0	0	0
£10,000	Gross weekly private pension (£)	11	9	6	2
	Final net weekly income (£)	189	187	180	174
	Net replacement rate without saving (%)	97	97	95	99
	Net replacement rate with saving (%)	102	101	97	99
	Improvement in net replacement rate from saving	5	4	2	0
£15,000	Gross weekly private pension (£)	24	20	14	4
	Final net weekly income (£)	200	196	187	180
	Net replacement rate without saving (%)	71	72	70	73
	Net replacement rate with saving (%)	79	78	74	74
	Improvement in net replacement rate from saving	8	6	4	1
£20,000	Gross weekly private pension (£)	37	30	21	6
	Final net weekly income (£)	210	207	199	187
	Net replacement rate without saving (%)	57	58	58	59
	Net replacement rate with saving (%)	66	65	63	60
	Improvement in net replacement rate from saving	9	7	5	1
£25,000	Gross weekly private pension (£)	49	41	29	7
	Final net weekly income (£)	220	217	209	195
	Net replacement rate without saving (%)	49	49	49	51
	Net replacement rate with saving (%)	58	57	55	52
	Improvement in net replacement rate from saving	9	8	6	1
£30,000	Gross weekly private pension (£)	62	51	37	9
	Final net weekly income (£)	230	226	217	205
	Net replacement rate without saving (%)	42	43	43	45
	Net replacement rate with saving (%)	52	51	49	46
	Improvement in net replacement rate from saving	10	8	6	1

Source: Department for Work and Pensions modelling.

2.4.2 Earnings dynamics

A variety of evidence suggests that earnings are highly dynamic and that relatively few people have persistently low earnings.

The Low Pay Commission (LPC) assessed the dynamics of low paid work to understand whether the National Minimum Wage (NMW) was used as a stepping-stone to higher wages or whether those paid at or below the NMW are trapped in a low wage – no wage cycle[22]. Their conclusions were consistent with that found in the United States[23], that minimum wage jobs tended to be entry-level jobs that are of relatively short duration for a large majority of workers. The report concluded that a substantial number of those paid at or below the NMW move after a short period into higher paid employment and, for over half of them, the upward adjustment in pay is in excess of ten per cent above the minimum.

Analysis of the British Household Panel Survey (BHPS) by the Institute for Social and Economic Research (ISER) found most people entering poverty could expect to be poor for only a short time, but there was a minority with longer spells. Relatively long spells were more likely to be experienced by women than men[24]. This was re-iterated in their 2006 report, which concluded that the turnover in the low income population was high[25].

We have also undertaken an analysis of the Lifetime Labour Market Database to look at earnings dynamics. We take a group of people in a particular earnings band and then see how many of them are still there the next year, then the year after that, and so on.

Table 2.3 gives an example of this analysis. It shows that, of men aged between 28 and 32 in 1978, with earnings of between £5,000 and £10,000 in that year, 78 per cent are in that earnings range or below for at least one year between 1979 and 2006. Only 27 per cent of these men have five or more years with annual earnings between £5,000 and £10,000 or below between 1979 and 2006.

Table 2.3: Earnings dynamics over time: males aged 28 to 32 with gross earnings between £5,000 and £10,000 in 1978 (2010/11 earnings levels)

Percentage

	Between 1979 and 2006				
Earnings *£000*	**One or more years**	**Two or more years**	**Three or more years**	**Four or more years**	**Five or more years**
5 to 10	54	31	17	11	6
5 to 10 and above	83	76	69	65	61
5 to 10 and below	78	61	45	35	27

Source: Lifetime Labour Market Database, Great Britain, Department for Work and Pensions.

22 Jones M K, Jones R J, Murphy P D, Sloane P J, November 2004, "The Analysis of Flows Into and Out of The National Minimum Wage", BHPS, LFS and Current Population Survey, Low Pay Commission.

23 Smith and Vavrichek, 1992, reported that over 60 per cent of workers in receipt of the minimum wage in 1984 were earning more than the minimum one year later.

24 Jones M K, Jones R J, Murphy P D, Sloane P J, November 2004, "The Analysis of Flows Into and Out of The National Minimum Wage", Low Pay Commission.

25 Jenkins S, "Poverty dynamics, Family background and attainment", BHPS waves 1 to 9, ISER 2006, http://www.ccsr.ac.uk/methods/festival/programme/lsw/jenkins.ppt.

All of this analysis supports the argument that earnings are actually very dynamic. It might make us more relaxed about low earning individuals being automatically enrolled than the replacement rate analysis suggests, not least because getting people into the habit of saving when they are on low earnings might increase the likelihood that they will continue saving once their earnings increase.

Even so, periods of low earnings are real, and there remains a question about the value of saving at those times when earnings are lowest.

2.4.3 Family circumstances

Perhaps a more important consideration in understanding whether a particular individual needs to save, is that of the circumstances of the family unit as a whole. It could be that a low-earning individual has a higher earning partner which means that, for the family unit as a whole, workplace pension saving would help to provide a decent replacement rate in retirement. The dynamics of family formation may also be important. It may be important for women in particular to be building up some saving for retirement on their own account even if they are earning a relatively small amount as part of a large household income.

Table 2.4: Family type and economic status (by individual gross earnings band) of individuals who would be automatically enrolled under the reforms

					Column percentage
	Individual gross earnings				
Characteristics	£5,000 to £9,999	£10,000 to £14,999	£15,000 to £19,999	£20,000 to £24,999	£25,000 and over
Family type					
Couple with children	38	25	25	27	33
Couple without children	31	37	38	38	38
Lone parent	11	6	4	2	2
Single without children	20	32	34	32	27
Economic status					
Single, in full-time work	6	30	36	33	28
Couple, both in full-time work	7	26	34	38	37
Couple, one full-time, one part time work	45	20	14	15	18
Couple, one full-time work, one not working	3	8	12	12	15
Single, in part-time work	25	9	2	1	1
Couple, both in part-time work	5	2	1	0	1
Couple, one part-time work, one not working	9	5	9	1	1

Note: Figures may not sum due to rounding.
Source: Family Resources Survey, United Kingdom 2005-06, Department for Work and Pensions.

Table 2.4 shows just how important family characteristics are. Of those individuals with gross earnings of between £5,000 and £10,000, just over two-thirds (69 per cent) are part of a couple, with or without children. Whether that partner is earning, and how much, will be an important factor in determining whether a particular individual should save or not.

Looking at the economic status of the family group starts to shed more light on this. Crucially, nearly half of those in the lowest earning group are in couples where one is in part-time work and the other in full-time work. Another quarter are single people in part-time work. Of these, 43 per cent are lone parents and 40 per cent are single people living with others, typically their parents.

Amongst those people in a couple, with a working partner, we can start to get a sense of the total earnings of that family. This is set out in Table 2.5. We can see that, in the vast majority of cases, the total gross earnings of the couple will be significantly higher than the earnings of one individual. If we focus on individuals earning between £5,000 and £10,000 who have a working partner, around 90 per cent have combined earnings of over £15,000. Three-quarters (78 per cent) have combined earnings of over £20,000.

Table 2.5: Gross earnings of couples where both partners work

					Column Percentage
	Gross earnings of individual who would be automatically enrolled				
Partner's earnings	£5,000 to £9,999	£10,000 to £14,999	£15,000 to £19,999	£20,000 to £24,999	£25,000 and over
Less than £5,000	4	4	8	9	12
£5,000 to £9,999	8	6	6	8	11
£10,000 to £14,999	11	12	8	8	8
£15,000 to £19,999	15	17	17	11	8
£20,000 to £24,999	16	18	18	19	10
£25,000 and over	46	43	43	45	51

Note: Analysis based on a couple who both have income from employment and/or self-employment. At least one of the couple must be an eligible jobholder without a qualifying scheme. The top categories always apply to an individual who is an eligible jobholder without a qualifying scheme. Where both members of the couple are eligible jobholders without a qualifying scheme, the top categories refer to the lower earner, with their partner's income described on the left side of the table.
Source: Family Resources Survey, United Kingdom 2005-06, Department for Work and Pensions.

Finally, we can look at what all this means in terms of where low-earning individuals sit within a household income distribution (after housing costs have been taken into account)[26]. Table 2.6 shows that those with gross earnings between £5,000 and £10,000 a year live in households spread very evenly across the income distribution. They are more likely to be in the second and middle quintiles than the population as a whole, and more than half are in the top three quintiles. In other words, having very low earnings is not a very strong indicator of being in the poorest households.

26 Analysis is consistent with that used in "Households Below Average Income", see http://statistics.dwp.gov.uk/asd/index.php?page=hbai.

Table 2.6: Where individuals sit in the household income distribution

	Column Percentage				
	Individual gross earnings				
Household income distribution	**£5,000 to £9,999**	**£10,000 to £14,999**	**£15,000 to £19,999**	**£20,000 to £24,999**	**£25,000 and over**
Bottom quintile	21	15	9	6	2
Second quintile	26	22	18	13	7
Middle quintile	25	29	29	24	14
Fourth quintile	17	22	29	38	28
Top quintile	11	12	15	19	49

Note: Quintile of the net equivalised after housing costs household income distribution.
Source: Family Resources Survey, United Kingdom 2005-06, Department for Work and Pensions.

All of this analysis suggests that attempting to determine the appropriateness of various earnings thresholds at an individual level grossly underestimates the importance of family units. The vast majority of low-earning individuals live in households with a working partner, and the majority of these partners have significant earnings. A significant proportion are also eligible for tax credits which, as we describe below, means they are likely to have a substantial incentive to save. It may, therefore, be entirely appropriate for a low-earning individual to save for a pension, helping to ensure that the family unit as a whole has a decent replacement rate and income in retirement.

The impact of this on earnings thresholds is discussed in Section 2.6.

2.5 Incentives to save

We have focussed so far on the question of who needs to save in order to smooth their income over time. We believe this is crucial. But more attention has probably been paid to the different question of incentives to save. Will people who are automatically enrolled get a good return on their contributions? Much concern has been expressed about the effects of means-tested benefits on these returns. Overall returns to pension saving are complex, affected by what levels of return from saving are thought to be acceptable, investment returns, annuity rates and the interaction with the tax and benefit system.

This section starts with a discussion around how we can measure returns from saving and then looks at what is an acceptable level of return from saving. It then moves on to consider various factors which influence returns before presenting evidence of expected returns for those who do save.

2.5.1 Measuring levels of return

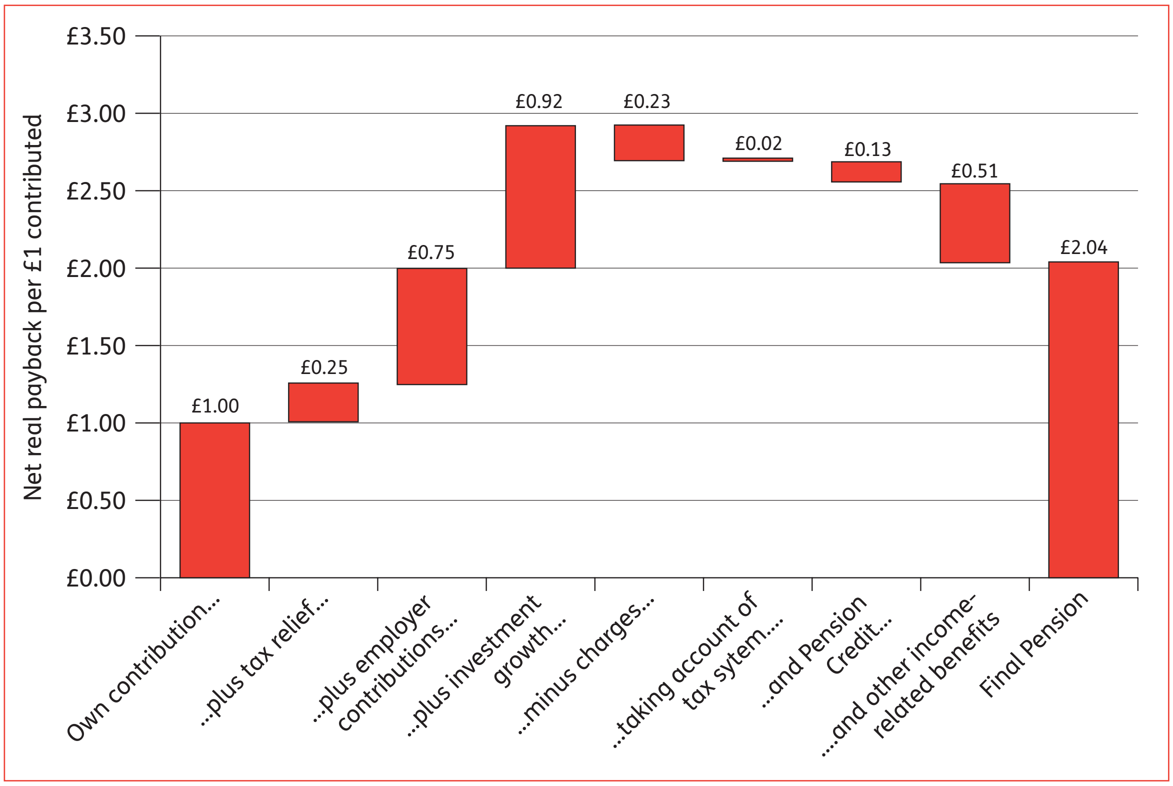
There are various ways to measure the return an individual sees from saving. One measure is to use a “payback calculation”. It takes account of expected investment returns, employer contributions, tax relief, inflation and income-related benefits that would have been received in the absence of private saving. Payback figures are presented in real terms, to take account of inflation over a lifetime.

Payback takes a stream of contributions made whilst working and compares that to an income stream in retirement. So a £2 payback means that each £1 saved is worth, on average, £2 over the course of retirement (technically, the £2 in this example is the net present value at retirement from the annuity purchased).

To illustrate payback for someone on a benefit taper in retirement, we can use a 'waterfall chart' which shows the elements that increase payback compared to those that reduce it. Chart 2.2 shows the saving situation of a hypothetical individual, a man on constant lower than average earnings who is automatically enrolled into an employer-sponsored pension scheme at age 25 in 2012. The chart shows the way in which his contributions and deductions from his pension influence the final amount he should expect in return for all of the inputs over his working life.

It shows that for each pound he contributes, over the life of his pension, he gets tax relief of £0.25, he gets an employer contribution of £0.75, and investment growth gives him £0.92. From that, he is deducted £0.23 for charges, and loses £0.64 of income-related benefits that he would have been entitled to in the absence of private saving. This means that, at the end of the day, his £1 will be worth £2.04 over the lifetime of his pension.

Chart 2.2: Waterfall chart illustrating payback for an example individual – male on 70 per cent of overall median earnings:



Source: Department for Work and Pensions modelling.

If someone receives a payback of £1 then they receive their own contributions back in real terms. Beating inflation over a long time period could be deemed to be an achievement in itself (most savings accounts currently offer a negative real rate of return, even before tax), and so a payback of £1 could be considered a good return. However, individuals may expect a positive investment return on their saving or compensation for loss of liquidity arising from tying their savings up in a pension they cannot access till their retirement and would therefore expect a payback greater than £1.

But a crucial issue in measuring levels of payback is how to take account of the role of the employer contribution and who pays for it.

If we believe that, for the individual, the employer contribution is effectively "free money", then we may judge that a £1 payback in real terms means maintaining the real value. But if we think that, in the end, the individual pays for the employer contribution, then we would want to see payback of at least £1.75 before accepting that the return is not negative (reflecting the £1 contribution from the individual and the £0.75 pence employer contribution that the individual also pays for).

At the macro level, employer contributions are clearly not "free money" – employers are likely to pass on at least some of the costs of pension contributions to employees in the form of lower wage growth, or less directly, higher prices.

At an individual level, the situation is different. The individual can remain in pension saving, following automatic enrolment, or they can opt out. If they opt out, they do not get the employer contribution and are unequivocally worse off. If they remain in, they do get the employer contribution and there is no additional "cost" to it.

The employer contribution should not be considered to be "free money". Nor will most individuals end up paying for all the employer contribution. We need to test payback against both these benchmarks.

2.5.2 Factors that influence returns

Tax relief

Tax relief is provided by the State on pension contributions to encourage people to defer income to later life. It means that an individual does not pay tax on their pension contributions whilst they are working, instead they pay the tax when they draw their pension. This can enhance returns, particularly if people drop down a tax band in retirement and so pay income tax at a lower rate than that of the relief received. 25 per cent of the pension pot can also be taken as a tax-free lump sum upon retirement, a further advantage of pension saving.

The IFS found, that even for people who do not drop a tax band in retirement[27], "The most favourable tax treatment [compared to a range of other assets, including ISAs, housing, stocks and shares]...is seen to apply to saving in private pensions, which gets upfront relief from income tax and allows an individual to benefit from a 25 per cent tax-free lump sum when he/she begins to draw his/her pension. Employer contributions to pensions also benefit from exemption from employee National Insurance contributions."

27 Wakefield M, 2009, "How much Do We Tax the Return to Saving?", IFS Briefing Note BN82.

Receipt of benefits or tax credits in working life

Receipt of working age benefits may also be an added incentive to save. Half an individual's contribution to a private pension scheme is disregarded from their income when calculating entitlement to income-related benefits, and is fully disregarded when calculating entitlement for tax credits. In other words, for many low income individuals in receipt of tax credits, the amount received in tax credits could be higher as a result of making pension contributions. For example, from 2011 those basic rate taxpayers entitled to Working Tax Credit with annual income above around £6,500, will receive an extra 41p in tax credits for investing an extra £1 in a pension scheme, implying a 61 per cent rate of tax relief on contributions. However, this incentive may not be enough to compensate for the loss of income from pension contributions for less well-off families.

Analysis of the Family Resources Survey[28] suggests that just over a third (36 per cent) of those earning between £5,000 and £10,000 a year who would be automatically enrolled under the reforms, are in receipt of tax credits. A further 24 per cent of these individuals earning between £10,000 and £14,000 a year are in receipt. For these groups, even though they have low earnings, the incentive to save is considerable.

Receipt of benefits in retirement

By definition, benefits targeted on those with the lowest incomes and wealth in retirement will not be awarded to those who have access to a sufficient amount of their own means. So some individuals will find that when assessed for benefit entitlement, their income in retirement is not much higher than it would have been if they had saved nothing at all.

Around 55 per cent of all pensioner households are estimated to be eligible for means-tested benefits in 2010, projected to fall to around 40 per cent by 2050[29].

The combined effects of different tax rates and tax credit receipt in work and in retirement are illustrated in Table 2.7. It shows how much money one would need to put into a pension to match the return from a £1 contribution in a savings vehicle like an ISA where savings are made from taxed income but no further tax is levied. The very big incentives to save for those on the tax credit taper in work are very evident, even for those who then end up on the Pension Credit taper in retirement. Only those who are basic rate taxpayers in work but end up on the Pension Credit taper in retirement suffer a disincentive. As it happens, this is not dissimilar to the disincentive to saving created by the standard income tax treatment of ordinary bank and building society accounts.

28 Family Resources Survey, United Kingdom 2005-06, Department for Work and Pensions. It is likely to underestimate the actual number of people in receipt.

29 Department for Work and Pensions modelling using Pensim2. Pensim2 is a dynamic micro simulation model that ages the individuals in a sample and simulates the key life events that occur from birth to death. It models pensions through to 2100.

Table 2.7: Contribution to pension required to match £1 contribution to an ISA for different combinations of working life and retirement tax rates

Tax rate in work	Tax rate in retirement	Required contribution *pence*
Basic rate (20%)	Basic rate (20%)	94
Higher rate (40%)	Higher rate (40%)	86
Higher rate (40%)	Basic rate (20%)	71
Basic rate (20%)	Pension Credit taper (40%)	114
Tax credit taper (59%)	Basic rate (20%)	48
Tax credit taper (59%)	Pension Credit taper (40%)	59

Note: Assumes 3 per cent real rate of return and 2 per cent inflation.
Employee contribution to a pension (10-year investment).
Source: Wakefield, M, 2009, "How much Do We Tax the Return to Saving?", IFS Briefing Note BN82.

Expected investment returns

Low investment returns have a large impact on overall pension pots in retirement, and will have the biggest impact on the retirement income of young individuals and higher earners in particular. PPI case study modelling[30] finds that a low return investment strategy (compared to a medium one) takes a median earner who begins investing at age 25 from being at 'low risk' of not getting a good return on saving to being at 'medium risk'. However, the same individual at age 55 stays in the 'medium risk' category.

Trivial Commutation

Pension rules allow for very small pots to be 'trivially commuted' – this means the whole pot is taken as a lump sum rather than being used to purchase an annuity. This will benefit those who have accrued relatively small pension pots, and as such will benefit those on low incomes who are automatically enrolled later in their working life.

Trivial commutation is allowed where all private pensions are below one per cent of the Lifetime Allowance. In 2010/11 the Lifetime Allowance is set at £1.8million, meaning that individuals with total pension entitlements worth up to £18,000 can receive this as a lump sum rather than a pension.

Individuals can have up to £10,000 of capital before it affects their entitlement to means-tested benefits in retirement. Individuals with very small pots can therefore trivially commute their pension and still claim means-tested benefits.

Annuity rates

An annuity is an income in retirement which is guaranteed until death. Annuity rates vary depending on the age, health and gender of the purchaser. Better annuity rates mean higher income in retirement.

Annuity rates are normally expressed in terms of a percentage and translate into the proportion of the pension pot at the time of annuity purchase that will be received each year; an eight per cent annuity rate means that a pension of £8,000 a year will be received from a pension pot of £100,000.

30 Pensions Policy Institute, 2010, "PPI Submission to the DWP Review: Making auto-enrolment work."

2.5.3 Evidence of expected returns

Population modelling from the Department for Work and Pensions using their Pensim2 Model[31] can be used to forecast expected payback.

At an overall level, the key findings from this analysis are that:

- Over 99 per cent are better off in retirement than if they had saved nothing.
- Over 95 per cent can expect to receive more than £1 plus inflation for every £1 saved.
- Just over 80 per cent can expect to receive more than £1.75 plus inflation for every £1 saved.

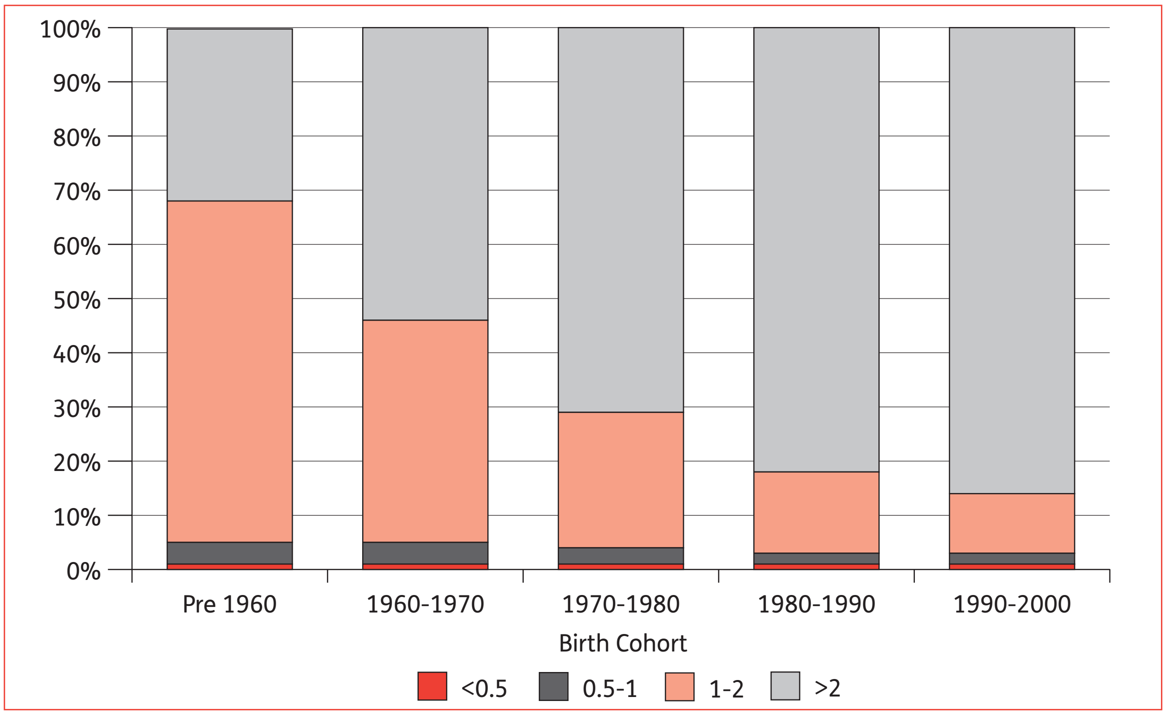
Expected returns by age

One of the concerns raised by stakeholders is the validity of enrolling older people. Chart 2.3 therefore looks at the distribution of payback for those in different birth cohorts.

It shows that levels of payback are higher amongst the younger birth cohorts than the older ones. That is because they have longer to build up savings and investment returns. It also shows the importance of defining what an acceptable level of payback is.

If a minimum acceptable level of payback is £1 – your own contributions back in real terms – then the majority of individuals at all age cohorts can be considered to do well from saving. However, if an acceptable level of payback is £1.75, then the picture is more varied, particularly for the older cohorts. Just over half of those born between 1960 and 1970 can expect a payback of £2, and this figure falls to around a third for those born before 1960.

Chart 2.3: Distribution of real payback from saving in a defined contribution pension with employer contribution after 2012



Source: Department for Work and Pensions modelling using the Pensim2 model.

31 Pensim2 is a dynamic micro simulation model that ages the individuals in a sample and simulates the key life events that occur from birth to death. It models pensions through to 2100.

So older cohorts face lower payback than younger cohorts and many will not even get back their own plus their employer's contributions.

That said, many of those without existing pension saving will be able to benefit from trivial commutation rules, taking some or all of their pension pot as a lump sum (which, if it falls under capital limits, will have no negative impact on their benefit entitlement).

Returns for "at risk" groups

DWP analysis suggests that there is no readily identifiable group who can be expected not to benefit from pension saving. The PPI[32] concluded in their analysis that 'suitability' will vary from person to person depending on how they are affected by the tax and benefit system, and the other factors discussed above; but these factors are not predictable at the point of automatic enrolment.

Certain characteristics are often associated with being at risk of low payback. The most common characteristics are:

- Having very deficient State Pension records and no other resources (so being eligible to receive significant amounts of Pension Credit).
- Having low State Pension and extra needs (e.g. receiving benefit top ups for an onset of disability in later life).
- Renting in retirement and being eligible for a combination of Housing Benefit and Council Tax Benefit.

These characteristics are likely to be relatively more common amongst those born before 1960. By contrast, those with the most likelihood of getting high returns are people enrolled at a young age on high or increasing earnings who are likely to own their own homes in retirement and be part of a couple.

The problem is that these characteristics can only be measured with any certainty retrospectively, when an individual is actually in retirement.

Interpreting the evidence on incentives to save is complex. Clearly many low earners can do well from saving. On the other hand, there are groups who will get very low returns. At an individual level, however, it is very hard to tell at the point of automatic enrolment who those individuals will be.

32 Steventon, A, 2006, "Are personal accounts suitable for all?", Pensions Policy Institute.

2.6 What does it all mean for the earnings level that triggers automatic enrolment?

The earnings threshold is one of the main policy levers that is available to change the group of people who are automatically enrolled under these reforms. We want to set a threshold which maximises pensions saving for those for whom saving is valuable, whilst minimising the number for whom it is not worthwhile. The first group for whom it may not be worthwhile are those whose income in retirement would not be much less than their income in work even without saving. The second group is those who may get a low return from saving as a result of the effects of the means-tested benefit system in retirement.

Our view is that it is the first of these issues that, in principle, could cause the most concern. It could straightforwardly lead to falls in people's lifetime welfare if they save when there is no need to. On the other hand, lifetime welfare could be enhanced even with very low returns to saving if there is very little smoothing without saving.

In practice, it is very hard to distinguish any clearly identifiable group or cut-off where one might say that those below this cut-off should not be saving and those above should be. If the world were simple and everyone always earned the same amount and always lived alone and there were no working tax credits, we would be inclined to argue for a significantly higher earnings threshold than is currently proposed, perhaps as high as £14,000 a year.

But the world is not simple. Many or most very low earners are women, who live in households with others with higher earnings and/or receive working tax credits. These may well be exactly the people who should be automatically enrolled.

Chapter 5 considers various earnings thresholds and the corresponding impacts in more detail.

2.7 Consequences of changes to the State Pension system

The discussion and analysis in this chapter is based on the current State Pension system. It is worth pausing to ask whether it would make any difference to the findings if State Pensions were to change.

Changes proposed by the NAPF for a Foundation Pension, for example, would combine the current Basic State Pension and State Second Pension into a single Foundation Pension payable to all people over State Pension age if they have accumulated at least 30 years of National Insurance contributions[33]. This would make the non-means-tested part of overall State Pension provision more generous.

Within the current system, low income groups see their income from the State Pension "topped up" by the means-tested Pension Credit. Moving to a Foundation Pension would therefore reduce their reliance on means-tested benefits, but it would not necessarily increase their overall level of income.

33 People with fewer than 30 qualifying years would receive a proportionate reduction.

In thinking about whether people need to save, our primary interest is in the level of income the individual receives in retirement, not where it comes from. Since a Foundation Pension type system, for low income groups, is likely to reduce means-tested support, not add to it, it will not have a significant impact on our analysis of who should be saving.

What it will do is change our understanding of who has good incentives to save. As we have previously seen, the incentive to save is heavily influenced by the interaction with means-tested support. Other things being equal, we could generally expect the incentives to save (and therefore payback) to improve as a result of a Foundation Pension type system.

This is supported by analysis carried out by the Pensions Policy Institute, which models the effect that a Foundation Pension at £8,500 a year increasing in line with the triple lock[34] would have on the incentives to save for individuals. Their analysis finds that, for the individuals they considered, a Foundation Pension would generally, but not universally, increase people's incentives to save.

2.8 Conclusion

Pension saving can be valuable because it allows individuals to smooth consumption between periods when they are relatively well off (when they are working) to periods when they have less money (when they are retired). Despite this, the overall level of private pension saving is low and falling.

Automatic enrolment is likely to prove an effective technique for increasing the overall participation level and should generate significant benefits in the form of greater consumption smoothing.

At an individual level, the analysis of replacement rates suggests that people on low earnings throughout their lives probably do not need to save. But earnings are highly dynamic and there are relatively few people who have low earnings throughout their lives. More importantly, most of those we are interested in live in family units and have a working partner with significant earnings.

Whether people have good incentives to save depends on a range of factors, including how we value the employer contribution, what returns look like and what the individuals' circumstances will look like in the future. The essential problem here is that the characteristics that are correlated with poor incentives are hard to predict in advance. What we do know is that individuals who choose to opt out do badly as they do not benefit from the employer contribution and also lose out from lower wage growth as employers seek to off-set the costs of automatic enrolment.

There is no earnings threshold that encourages saving amongst all those who need to save while excluding all those for whom the value of saving is more questionable. A relatively low earnings threshold has the benefit of encouraging those with a working partner, those who will go on to earn more and those in receipt of tax credits to save. But it also encourages persistently low earners to save. A higher earnings threshold does the reverse.

34 From 2011 the Basic State Pension will be annually uprated under a 'triple lock' i.e. it will increase in line with the higher of earnings growth, price inflation (the RPI in 2011 and the CPI in subsequent years) or a fixed 2.5 per cent.

Employers 3

Summary

In this chapter we explore how the proposed reforms impact on employers.

Automatic enrolment will have a major impact on employers. They will have a new and significant set of responsibilities with which they have to comply.

The large majority of employers are very small. Two thirds, about 800,000, have fewer than five employees. Most small and micro employers have no experience of dealing with pensions. Their duties under this policy will involve them in, for many, an entirely new set of issues.

Bigger employers are much more likely to run pensions schemes. For them, key considerations will be whether their current scheme meets the automatic enrolment minimum standards and what automatic enrolment will mean for the level of participation in their scheme.

Costs to employers can be divided into two distinct elements. First, the contribution costs to the employer of providing the three per cent minimum contribution to employees who remain in pensions saving. These costs represent a transfer to the employee, rather than a pure cost in economic terms. By contrast, administrative costs – for example the cost of setting up a pension scheme, automatically enrolling employees, calculating and deducting contributions, and registering with The Pensions Regulator – represent a true economic cost.

We want to minimise these administrative costs as far as possible and ensure that they are proportionate to the benefits of automatic enrolment in terms of the additional pension saving generated, particularly for the smallest employers, for whom the reforms have potentially the greatest impact. Inevitably, the cost per employee enrolled will be much higher for smaller employers. In addition, the costs for the Pensions Regulator of dealing with many hundreds of thousands of small employers will be large.

3.1 Introduction

The driving force behind automatic enrolment is that too few people are saving enough to provide the standard of living they would like in retirement. Allied to this is a gradual decline in the provision of workplace pension schemes and, in particular, defined benefit schemes, although many people do work for firms that offer pensions of which they do not take advantage. The premise of the proposed reforms is that, short of requiring people to save, the best means of encouraging saving is to automatically enrol individuals into a pension. This requires the provision of a pension scheme in which to save and someone to carry out the automatic enrolment process. In the context of the UK pension provision, this role falls most naturally on an individual's employer.

Undertaking this role inevitably carries a cost for employers, both in terms of their own contributions to an individual's pension and in administering automatic enrolment. As explained in Chapter 1, under the current policy design, employers are required to make a minimum contribution of three per cent of a band of earnings between £5,035 and £33,540 (2006/07 prices, to be uprated in 2012). For many employers, particularly the smallest employers, providing workplace pensions will be an entirely new role, with a new administrative burden in addition to the costs of making contributions. As the reforms are currently intended to apply to any employment relationship, many people we might describe as "accidental employers" will be caught up in the requirement to automatically enrol their contracted workers – for example, those employing carers and nannies.

A central question for the review to consider is whether this burden on employers is both necessary and proportionate in achieving the policy aims of increasing retirement saving, and whether there are opportunities for these costs to be reduced.

This chapter examines the implications of pension reform for different types of employer (Section 3.2), the administrative costs associated with pensions reform (Section 3.3), the contribution costs for employers (Section 3.4), the role of The Pensions Regulator in ensuring compliance with the duties (Section 3.5) and evaluation of the regulatory burden employers face (Section 3.6).

The analysis in this chapter informs discussions on profitability in the pensions industry (Chapter 4 and 7), the discussion of changes to the target group for automatic enrolment (Chapter 5) and the deregulatory options to simplify the administrative processes for employers and schemes (Chapter 6).

3.2 Implications of the reforms for employers

The duties set out in the 2008 Pensions Act will apply to all companies or individuals who employ one or more workers in Great Britain. Complying with the reforms will entail new roles and processes for all employers, for example in carrying out automatic enrolment into a workplace pension and in registering with The Pensions Regulator. In addition, for many employers, and particularly small (fewer than 50 employees) and micro (fewer than five employees) employers, the process of providing a workplace pension in itself will be new. Employers with existing pension provision will have to go through new processes to ensure that their schemes comply with the requirements for scheme quality, and to take decisions regarding their contribution levels.

3.2.1 Employer processes under the reforms

During implementation, employers are brought into the duties in a managed way called 'staging'[35]. This staging period runs from October 2012 to September 2016. Employers are assigned a staging date, when they must first automatically enrol eligible workers into a qualifying workplace pension scheme. The largest employers are staged first (using PAYE scheme size as a proxy for employer size) through to the smallest. New firms coming into being after October 2012 will be brought into the reforms at the end of the staging period. All employers will receive letters from The Pensions Regulator 12 months and then 3 months ahead of their staging date. The letter will tell them when their staging date is and what they must do to comply with their automatic enrolment duties. The Pensions Regulator will publish guidance to help employers understand their duties.

Employers will have to undertake a series of tasks in order to comply with the new duties. Figure 3.1 sets out the time line for the step by step processes. Employers must:

- Offer a qualifying pension scheme with a minimum contribution of eight per cent of a band of qualifying earnings, with at least three per cent from the employer for defined contribution schemes.[36]
- Automatically enrol all eligible jobholders on their staging (automatic enrolment) date[37] and make contributions to a qualifying pension scheme during a one-month joining window.
- Provide information to jobholders during the one-month joining window to let them know they are being automatically enrolled and have the right to opt-out in the month after automatic enrolment.
- Facilitate opt-out and make refunds to those who have opted out.
- Register with The Pensions Regulator and provide them with information on how they met their automatic enrolment duties within two months of their staging date.

After their initial staging date, employers must do the following on an ongoing basis:

- Identify and automatically enrol newly eligible jobholders on day one of their employment or who are newly eligible because they have reached age 22 or have qualifying earnings.
- Process workers who opt-in to pension saving, making an employer contribution if a jobholder is between age 16 and 21 or between state pension age and 74 with qualifying earnings, but not being required to make an employer contribution if the worker does not have qualifying earnings.
- Provide information to jobholders.
- Administer opt-outs and refunds within the prescribed time periods.

35 3% employer contribution at the end of the implementation period. During implementation, contributions are phased in for money purchase schemes at 1% from October 2012 to September 2016, at 2% from October 2016 to September 2017 and at 3% from October 2017.

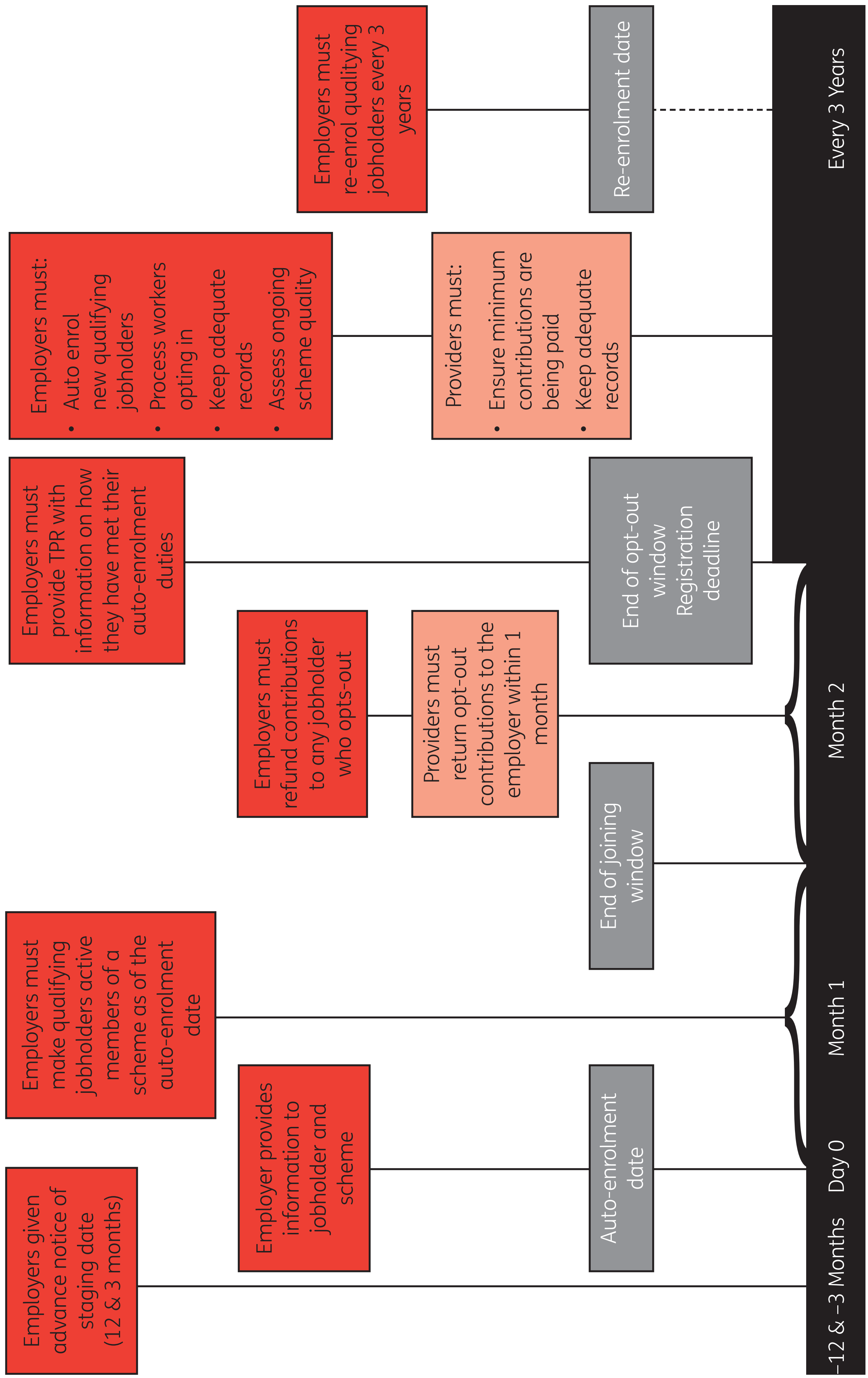
36 For Defined Benefit schemes all schemes contracted out of the State Second Pension will be considered compliant. Other non-contracted out schemes must meet the 'Test Scheme Standard'. The employer compares the benefits received under their scheme to those under the 'Test Scheme' which includes accrual rate of 1/120th. Hybrid schemes must satisfy the DB and DC test in proportion to the benefits provided.

37 Employers with a staging date on or after 1 November 2012 can bring forward their staging date to another staging date prescribed in the regulations so long as they have a qualifying scheme that will accept them and have registered with The Pensions Regulator.

- Re-enrol eligible jobholders who opted out of the scheme on the third anniversary of the employer's staging date.
- Keep records (for a minimum of six years) about jobholders, workers and about the pension scheme, demonstrating how they have complied with the duties under the Act.

Section C.2.1 in Annex C provides further information about the detailed processes employers must follow to comply with their duties.

Figure 3.1: Employer processes



3.2.2 What the reforms mean for different types of employers

Employers will face additional contribution costs as a result of these reforms. We discuss in Section 3.4.3 how employers might choose to finance contribution costs. Contribution costs represent a real cost to employers but, as the money is transferred to the employee, in economic terms these constitute a "transfer payment" rather than a true economic cost. Many employers tend to see the rationale, and the benefits to the employee, of the contribution costs. DWP research in 2006 reported that six in ten employers felt that a minimum employer contribution was a good idea[38], and in the Association of Consulting Actuaries' 2010 survey of small and medium sized firms, fewer than two in ten respondents felt that the employer contribution should be reduced, with a quarter thinking the levels should be increased[39].

The administrative cost to the employer of setting up and administering automatic enrolment is, by contrast, a pure economic cost from which nobody gains. These should, therefore, be minimised as far as possible.

The size of the contribution costs, and to some extent of the administrative costs, is dependent on the employer's existing pension and administration arrangements. Employers with existing good quality schemes will have to do less in the way of new administration to comply with the reforms, and will face smaller additional costs of contributions compared with employers who have no provision. Thus, in order to understand the impacts of the reforms, we must first look at who the employers are.

There are currently 1.2 million private sector organisations in the UK, employing a total of 19.2 million individuals. Table 3.1 shows key information about UK employers, with a particular focus on the smaller employers [40], who will have the greatest per employee burden associated with automatic enrolment.

Overall, we can see that the majority of UK employers are small or very small but employ a minority of the workforce: while micro employers represent 66 per cent of all employers, they employ only 12 per cent of the workforce. The majority (72 per cent) of workers are employed by firms with at least twenty employees. This means that strategies targeted at reducing burdens for micro employers would potentially have a more limited impact on workers.

There are no apparent relationships between gender distribution and employer size, but there seems to be a consistent relationship between employer size and average salary of their workforce. For companies who employ at least twenty workers, seven in ten of their employees earn at least £15,000 per annum. By contrast, only around four in ten individuals who work for micro employers earn £15,000 or more.

Annual job churn will be a key factor in the cost of complying with the reforms, as this will dictate the numbers of automatic enrolment processes and scheme leavers employers will have to process and the size of the scheme records they must keep. There is a trend in job churn by employer size, with the smallest firms having the highest proportion of workers with less than a year's tenure. Even the largest firms experience around ten per cent annual workforce churn, with an average of 14 per cent overall.

38 Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, "Employer attitudes to personal accounts: Report of a quantitative survey", DWP Research Report No 397.

39 ACA, 2010, Survey of smaller firms views on automatic enrolment and NEST.

40 Throughout our analysis in this chapter we disaggregate small (with fewer than 50 employees) and micro firms (with fewer than five employees) into sub-groups.

There is also a clear relationship between pension provision and firm size, with larger companies being much more likely to provide any access to pension schemes, and to provide a contribution. This means that the smallest companies will be disproportionately affected by the costs of pension reforms. Whilst pension scheme membership tends to be high where micro employers offer pension provision, so few do so that the majority will be facing contributions for the first time.

Table 3.1: Summary of key employer characteristics

<table>
<tr><th></th><th colspan="6">Employer size number of employees</th></tr>
<tr><th></th><th>1</th><th>2-4</th><th>5-9</th><th>10-19</th><th>20 +</th><th>All</th></tr>
<tr><td>Employers row percentages</td><td>16</td><td>50</td><td>18</td><td>9</td><td>6</td><td>100</td></tr>
<tr><td>Proportion of total UK workforce row percentages</td><td>2</td><td>10</td><td>8</td><td>8</td><td>72</td><td>100</td></tr>
<tr><td colspan="7">Earnings of workers employed by firms within each size category column percentage</td></tr>
<tr><td><£5,000</td><td>13</td><td>13</td><td>11</td><td>9</td><td>8</td><td>8</td></tr>
<tr><td>£5,000 – £9,999</td><td>28</td><td>25</td><td>17</td><td>13</td><td>11</td><td>12</td></tr>
<tr><td>£10,000 – £14,999</td><td>21</td><td>19</td><td>18</td><td>17</td><td>13</td><td>14</td></tr>
<tr><td>£15,000 – £19,999</td><td>15</td><td>15</td><td>17</td><td>17</td><td>15</td><td>16</td></tr>
<tr><td>£20,000+</td><td>24</td><td>29</td><td>37</td><td>44</td><td>53</td><td>51</td></tr>
<tr><td>Proportion of workforce who are women percentage</td><td>44</td><td>48</td><td>46</td><td>44</td><td>50</td><td>50</td></tr>
<tr><td>Annual workforce churn percentage</td><td colspan="4">17</td><td>12</td><td>14</td></tr>
<tr><td>Proportion of employers offering any pension provision percentage[1]</td><td>8</td><td>5</td><td>24</td><td>33</td><td>52</td><td>15</td></tr>
<tr><td>Proportion of employers offering pension provision with a contribution percentage[1]</td><td>8</td><td>3</td><td>20</td><td>24</td><td>44</td><td>12</td></tr>
<tr><td>Average proportion of employer’s workforce that are members overall (those with provision only) percentage[1]</td><td>–</td><td>76</td><td>46</td><td>44</td><td>31</td><td>32</td></tr>
<tr><td>Average proportion of employer’s workforce that are members of a pension scheme AND receive employer contributions (those with provision only) percentage[1]</td><td>–</td><td>53</td><td>41</td><td>36</td><td>29</td><td>30</td></tr>
</table>

1 Only including employers with at least one active member.

Sources: Small and Medium Enterprise Statistics, United Kingdom 2008, Department for Business, Innovation and Skills.
Annual Survey of Hours and Earnings, Great Britain 2009, Office for National Statistics.
Employers’ Pension Provision Survey, Great Britain 2009, Department for Work and Pensions.

Overall, we can divide employers into five broad groups, based on the degree of change they will have to make to their existing pension arrangements in response to the reforms. The first two of these five groups will face the least change. They are familiar with making decisions about pension provision, and can be confident that they already contribute enough to meet minimum quality requirements. These employers may want to use the simple certification process for scheme quality described in Chapter 6.

(1) Employers who currently contribute at least six per cent to a scheme with unrestricted eligibility

Around 45,000 employers fall into this category, representing 3.5 per cent of the total UK employer population. Larger employers are over-represented in this group, which accounts for 19.5 per cent of the total UK workforce. Three in ten of the largest employers (500+ employees) fall into this group, compared with only two per cent of micro employers.

(2) Employers who currently contribute at least six per cent to a scheme but restrict eligibility through waiting periods

Around 11,000 employers fall into this category, representing just less than one per cent of the total UK employer population. No micro employer falls into this category, with nearly three-quarters being small firms and just under a quarter being medium-sized (50 – 249 employees). This group employs 7.5 per cent of the UK workforce, and tends to have high scheme membership rates.

On the whole, definitions of pensionable pay are more generous than the definition of qualifying earnings under the Pensions Act 2008, so employers currently making contributions of six per cent or more of pensionable pay are contributing in excess of the minimum required by reform. They will have to make some administrative changes to introduce automatic enrolment and, potentially, to extend eligibility criteria, but most will already have computerised administrative systems and may have dedicated staff to undertake such activities. Participation rates are high across firms contributing more than five per cent, so this group of employers will face the smallest proportional increase in costs due to contributions. This group also have the option to offset increases in contribution costs through levelling down. As such, we are not focusing on these first two groups of employers in deciding on potential changes to the reform policy.

The other three groups of employers have no or limited experience of pension provision. Where they do provide a pension, it may not meet the quality requirements under the reforms.

(3) Employers who currently contribute between two and five per cent

This group of employers have reasonable provision, but due to the differences between the current basis for pension calculations and the definition of qualifying earnings under the 2008 Act, this group of employers cannot be confident that their schemes meet minimum contribution requirements. Six per cent of all employers fall into this "marginal provision" category, accounting for 22.7 per cent of the UK workforce. Half of all large firms, and three in ten very large firms come into this category, compared with only two per cent of micro employers.

These employers have experience of pension provision, but will potentially face complex and burdensome calculations to decide whether or not their schemes qualify under automatic enrolment. They may have to make changes to eligibility criteria, as well as introducing automatic enrolment. We are keen to reduce the regulatory burden for these employers as far as possible, making it easier for such firms to determine whether their schemes qualify.

(4) Employers with very low quality pension provision

This is a relatively small group of 48,000 employers representing four per cent of the total UK employer population. Nearly two thirds of these employers are small, with a further quarter being micro employers. This group of employers accounts for nine per cent pent of the UK workforce.

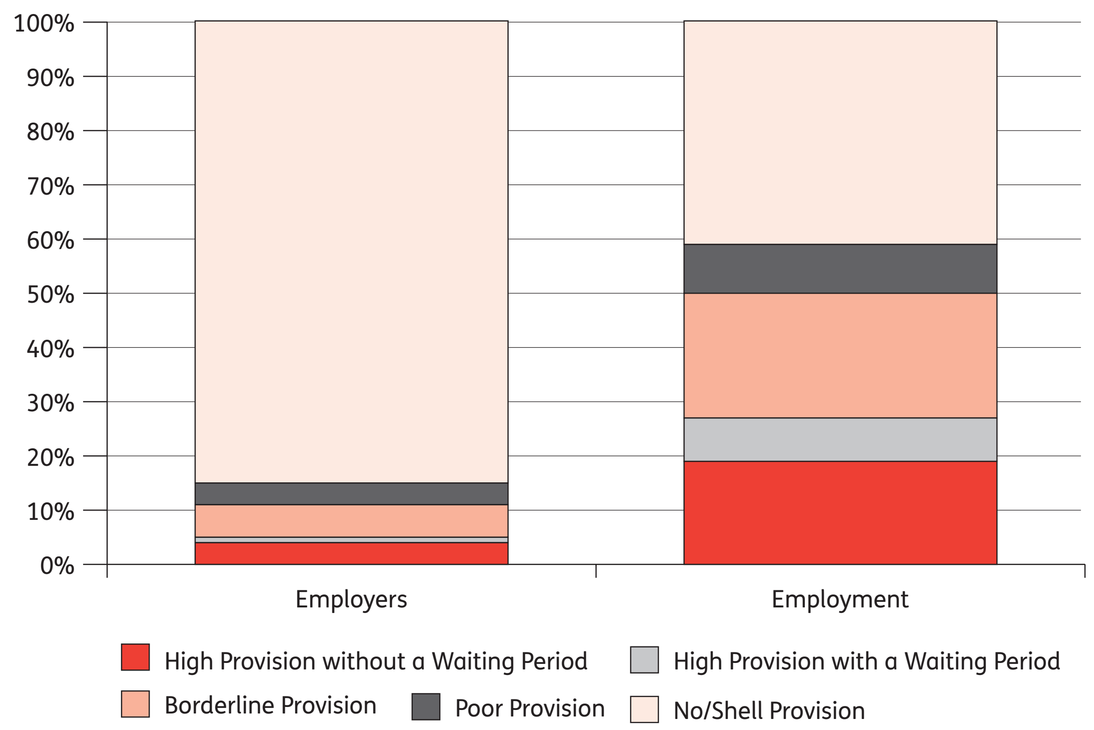
While this group of employers offer a workplace pension scheme, the current contribution rates are too low to meet the minimum scheme quality requirements for automatic enrolment. These employers will either need to increase the contributions to their current scheme or offer a new scheme with a higher contribution rate. Participation in these schemes is also lower than higher quality schemes, meaning that these employers will have proportionally more automatic enrolment activity to undertake at implementation than other existing providers. As this group is mainly populated with small and micro employers, it will have high rates of employee churn and so will also have to undertake proportionally more automatic enrolment activities per year than other groups of existing providers.

(5) Employers with no pension provision

These employers, primarily micro employers without pension provision and small employers with empty stakeholder schemes, make up 86 per cent of UK employers, and employ more than 40 per cent of the workforce. 94 per cent of all micro employers and 71 per cent of small employers fall into this category, along with two fifths of all medium sized firms, three in ten large firms, and two in ten very large firms.

Many of these employers will have to make decisions about pension provision for the first time and will have no experience of any of the processes involved in complying with the duties. Given the predominance of small and micro employers, this group also has the highest rates of employee churn, between 14 and 17 per cent, and will have to undertake proportionally more automatic enrolment activities per year than other groups of employers. Most will also be making contributions for the first time and thus face the highest proportional costs of all employers. We are very concerned to reduce the regulatory burden on these employers as far as possible and, in particular, to ensure that the costs of complying with the duties do not outweigh the contributions made on behalf of members.

Chart 3.1 illustrates the proportion of employers and employees falling into each of these five categories.



Source: Employer Pension Provision Survey 2009, Department for Work and Pensions.

3.2.3 Current pension provision and its quality matter

The existence and quality of current pension provision by employers is crucial to our grouping of employers in Section 3.2.2. This section explores in more detail the extent, type and coverage of current pension provision, the quality of schemes, and current joining methods.

Number and type of schemes

In 2009, 38 percent of private sector employers made some form of pension provision for their employees, albeit some of these have no active members in their schemes and some employers (five per cent of all employers) made contributions to individuals' personal pensions rather than providing a workplace scheme. Pension provision is more common among larger organisations than among smaller ones. Consequently, the proportion of private sector employees who worked for a pension-providing employer was considerably higher (86 per cent), although not all of these employees will be eligible to join their employer's scheme, and, in fact, only 37 per cent, or 7 million, employees were members of pension schemes[41].

41 Bewley H and Forth J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683

The most common form of provision was a stakeholder pension scheme (SHP) (provided by 27 per cent of employers with provision), followed by contributions to employees' private personal pensions (14 per cent of employers with provision). Small proportions of employers provided either group personal pensions (GPP) or occupational pension schemes, around one in twenty in each case. The providers of occupational schemes and GPP schemes tend to be relatively large, however, and so 49 per cent of employees work for companies with occupational schemes and 30 per cent for employers with GPP schemes.

Most employers with workplace pension provision have a single workplace pension scheme (79 per cent). Some employers provide more than one scheme. Just over half of these employers have different types of schemes, for example occupational and stakeholder pension schemes, which they may offer to different types of employees. The provision of multiple workplace schemes was more common in larger organisations and, for this reason, 64 per cent of employees in organisations with workplace pension schemes were employed by an organisation with more than one workplace scheme. This corresponds to around half (52 per cent) of all private sector employees working for a company with more than one workplace pension scheme. This differentiation in provision for different groups of employees suggests that, once the reforms are in place, some larger employers may seek to use alternative provision, possibly including NEST, for some parts of their workforce, while retaining existing schemes for current members or members who have been with the employer for, say, two years.

Scheme quality: contributions, pensionable pay definitions and charge levels

Around four-fifths (79 per cent) of employers who offered access to a pension scheme made a contribution, with the contribution rate most commonly being at least six per cent of an employees' salary (Table 3.3). Larger firms tend to be more likely to make contributions (Table 3.2), and contribution rates are highest, on average, for occupational schemes (Table 3.3).

Table 3.2: Employer contribution rates in the employer's largest scheme by employer size

	Employer size *number of employees*						
Rate of contribution to largest scheme	**1-9**	**10-19**	**20-49**	**50-249**	**250-499**	**500+**	**All**
Less than 3%	4	4	11	16	7	2	6
3% exactly	6	16	13	8	6	4	9
3.1%-5.9%	19	21	23	36	26	23	21
6% or more	51	41	33	28	51	54	45
No contributions	21	19	21	12	10	16	20
Weighted base	*236*	*71*	*48*	*33*	*4*	*5*	*397*
Unweighted base	*64*	*120*	*227*	*521*	*228*	*362*	*1522*

Base: All employers offering access to a pension scheme.
Source: Bewley, H and Forth, J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

Table 3.3: Employer contributions rates in the employer's largest pension scheme, by scheme type

				Percentage
	Stakeholder pension scheme	**Group personal pension**	**Occupational pension scheme**	**All**
Any employer contribution	71	94	93	79
Contribution rate:				
Zero	29	6	7	21
0.1-2.9%	7	5	2	6
3.0% exactly	7	19	1	9
3.1-5.9%	18	39	6	21
6.0%+	40	30	84	44
Weighted base	*260*	*79*	*58*	*397*
Unweighted base	*543*	*590*	*390*	*1,523*

Base: Largest workplace pension scheme, with some active members.
Source: Bewley, H and Forth, J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

Contribution rates are only one measure of scheme quality, since the basis on which contributions are calculated can vary between employers, meaning that a six per cent contribution from one employer may be worth more or less than a six per cent contribution from another. "Pensionable pay" can include varying proportions of basic pay (salary) and additional elements of total pay (including overtime, commission, bonuses etc.). On average, however, basic pay tends to make up more than 90 per cent of total pay.

Under the Pensions Act 2008, the total minimum contribution to defined contribution schemes must be equivalent to eight per cent of "qualifying earnings", which comprises a band of gross earnings, between £5,035 and £33,540 (in 2006/07 terms). Gross earnings include salary, commission, bonuses, overtime, sick pay, and maternity and paternity pay. For many employers, there is likely to be a mis-match between their definition of pensionable pay and the definition of qualifying earnings. However, contributions based on pensionable pay exceed contributions based on the definition of qualifying earnings for 90 per cent of members across all sizes. A simple certification process to help employers check whether their scheme meets the quality requirements is discussed in Chapter 6.

Another key element of scheme quality is the level of charges paid by members and the extent to which this represents value for money. For example, for a median earner with a full saving history, an annual management charge of 0.5 per cent would reduce their final fund value by nine per cent, but, if the charge is set at 2.5 per cent, they would lose up to 37 per cent of their total fund value. Chapter 4 discusses charge types and profitability for pension providers and also sets out the impact that charge levels have on members' funds (Chart 4.1).

The majority of occupational scheme charges are paid wholly or partly by the employer, but one in five are paid wholly by the employee[42]. The most common percentage fund charge level is one per cent. Charge levels usually decline as schemes get larger, and the smallest schemes are charged at a level nearly twice as high as the largest schemes (mean level of 1.53 per cent for schemes of under 12 members compared with 0.84 per cent for 100+ members).

Basic annual charge levels on contract-based schemes are similar to those in trust-based schemes, but are generally paid by the member rather than the employer. Based on information provided by eight insurers, covering over 3,000 schemes, for around one-third of schemes the standard basic annual management charge is lower than 0.8 per cent, while, for almost half (45 per cent) of schemes sold by providers, annual management charge levels are one per cent or higher. AMCs tend to vary with scheme size, with smaller schemes attracting slightly higher charges; nevertheless, the majority fall at or under the stakeholder charge cap of 1.5 per cent in the first ten years and 1 per cent thereafter (see Table C.2.2.1 in Annex C).

Scheme membership rates

Unsurprisingly, participation in pension schemes varies by the level of contribution offered by the employer. Where the employer offers no contributions, only around three in ten employees join the scheme on average. By contrast, where the employer offers contributions of six per cent or more, almost two-thirds of employees on average join the scheme. There is corresponding variation by type of scheme: stakeholder schemes attract only two in ten employees, whereas occupational schemes attract almost seven in ten employees. This is because type of scheme tends to be a flag for level of contribution, with occupational schemes having the highest, and stakeholder schemes the lowest, average employer contributions (see Table C.2.2.2 in Annex C).

Eligibility criteria & joining mechanisms

Even among schemes that are open to new members, some employers operate waiting periods or have other eligibility criteria restricting scheme membership. A third (33 per cent) of employers with pension provision used a waiting period and just over one in ten used some other form of eligibility criterion, either on its own (eight per cent) or in combination with a waiting period (four per cent). These criteria included: senior management only, employees having to be over a certain age, white collar or blue collar employees only, or all in a particular business group. (See Table C.2.2.3 in Annex C).

For organisations where a waiting period was in operation before joining a pension scheme, the majority (64 per cent) operated a waiting period of 6 months or under. This includes a third (33 per cent) who required employees to wait for 3 months or less before joining a scheme. There were no clear variations by employer size, but those who made contributions to their employees' pensions were less likely to offer an unrestricted scheme than those who did not contribute (48 per cent compared with 62 per cent). Chapters 5 and 8 discuss our recommendations for a waiting period. (See Table C.2.2.4 in Annex C).

42 DWP survey of occupational scheme trustees and of insurers provides a summary of charge levels across both contract-based and trust-based schemes: Croll, A, Vargeson, E and Lewis, A, 2010, "Charging levels and structures in money-purchase pension schemes: Report of a quantitative survey", Department for Work and Pensions Research Report No 630.

The cornerstone of the pension reforms will be the introduction of automatic enrolment into pension schemes. Under this legislation, for the first time individuals will be put into pension schemes without providing any form of consent beforehand. Whilst this is not currently possible, some employers try to make it easier for their employees to join a pension scheme by simplifying the joining process in some way, up to and including a form of “automatic enrolment” (in which the individual is given the opportunity to opt out of joining before they are put in the scheme). Of those employers who offered access to pension provision in 2007, a third use a streamlined process (32 per cent), and six per cent used some form of “automatic” joining process (See Table C.2.2.5 in Annex C).

The joining method chosen had a dramatic effect on membership levels, with around eight in ten eligible employees joining a pension scheme via an “automated” process, compared with only a third where they were required to complete a detailed form. This is in line with the Pensions Commission’s core reasoning behind the pension reforms, that automatic enrolment harnesses inertia to improve pension take up.

3.3 Administrative costs for employers of complying with the reforms

“Administrative cost” refers to the cost to the employer of carrying out the various activities needed to meet the automatic enrolment requirements. Often, this will depend on the time taken to carry out the activity, the hourly wage of the individual carrying out the task and how many times the task must be completed.

To some degree, we can learn about the potential administrative burdens of pension reform by examining the impacts of other regulatory regimes that have required employers to undertake new administrative processes. DWP research[43] has attempted to explore administrative burdens by asking employers about the overall effects of legislation such as maternity/paternity leave rights, the stakeholder pension requirements and HMRC moving to electronic filing of tax returns.

Typically, small employers said they relied on outsourcing services and seeking external advice and, therefore, they found the process quite manageable. Those operating payroll in-house were heavily reliant on their software provider for automatic updates to help them deal with previous legislation such as the minimum wage, or change in VAT. They were positive about how useful these were in making such changes trouble free. When difficulty had arisen with previous changes, this was due to two key issues:

- Complexity: Small employers struggled most with reforms that required a large amount of paperwork and legal advice that could not be generalised to all employees. The more complex the employers found the legislation, the more the cost of dealing with the legislation would increase as employers spent more time implementing it and there was a greater likelihood of them having to seek external advice.

- High up-front costs: Implementing previous legislative reforms became more of an issue, or perhaps more memorable, for small employers, when they involved a high degree of cost up front.

43 Philpin, C and Thomas, A, 2009, “Understanding small employers’ likely responses to the 2012 workplace pension reforms”, Department for Work and Pensions Research Report No 617.

Broadly, we can divide the administrative duties associated with automatic enrolment into four groups. Preparing for start up involves investigating existing schemes, taking internal decisions about how best to provide a qualifying scheme, training staff and communicating with employees. Enrolment involves providing information to eligible jobholders, enrolling them, dealing with opt outs, passing information to the scheme etc. Collection and administration involves calculating and deducting contributions, paying them over to the scheme and dealing with requests to stop payments. Finally, registration involves interacting with The Pensions Regulator to provide information on the activities the employer has taken to meet their duties.

For employers with no previous experience of pension provision, the upfront costs may be relatively high, in researching and setting up a new pension scheme, and, potentially, in making changes to their payroll systems.

DWP has estimated the administrative costs to employers across different sizes, covering both first year costs and ongoing costs in steady state (Section 3.3.2). We have also explored employers' views of the potential administrative costs of the reforms, directly through consultation (Section 3.3.1).

We have also looked for comparisons with equivalent pension regimes in other countries. A number of other regimes bear some comparison with the British pension reforms, including Australia, Canada, Denmark, Norway, Sweden, Poland, Uruguay and, the closest comparator, New Zealand. However, a systematic review of these case studies has revealed very little information about administrative burdens on employers[44]. Early evidence from New Zealand suggests that employers did not experience a significant administrative burden, with the most onerous tasks involving learning about the reforms and communicating to employees.

3.3.1 Stakeholder views

The regulatory burden of the reforms is a concern for employers. As part of our consultation process we asked specifically for views on the administrative costs for employers and any ways in which these could be reduced.

Generally, employers are most concerned about the set-up costs associated with putting qualifying schemes in place, making changes to administrative systems, providing information to employees and so on. Employers are particularly concerned about the burdens of choosing a scheme, and being seen to provide advice to employees and the risk of litigation if they give the wrong advice or select a scheme that performs poorly.

Some stakeholders have also described the opt-out and refund processes, in particular, as clunky and burdensome. Another key area of concern is 'certification': the process by which employers can determine whether their existing scheme meets the quality requirements.

44 Collard, S and Moore, N, 2010, "Review of international pension reform", Department for Work and Pensions Research Report No 663.

There are some concerns about ongoing processes in steady state, particularly around the burdens of re-enrolment and re-registration. Some employers also raised concerns about the administrative burden of processing employees on zero-hours contracts, since these individuals are likely to go in and out of pension saving as their earnings fluctuate. Unsurprisingly, employers have consistently said, both in consultation and in DWP's research, that a waiting period would help companies with high turnover by eliminating the costs of enrolling and un-enrolling significant numbers of employees every year.

Chapters 5 and 8 discuss the proposals for a waiting period and Chapter 6 discusses other suggested deregulatory changes.

3.3.2 Estimating the administrative costs for employers

The DWP have estimated the additional cost to employers of complying with the new duties. This work follows the standard cost model methodology recommended by the Better Regulation Executive. The employer administrative costs take into account the range of new activities employers will need to perform to fulfil their legal obligations. These can be categorised into four high level groups, which capture the processes described earlier: preparing for start-up; registration; enrolment; and collection and administration.

Tables 3.4 and 3.5 show the estimated administrative costs for employers in Year 1 and on an ongoing basis split by firm size and activity. Table 3.6 shows the administrative costs per person automatically enrolled by firm size. Year 1 costs for all firms are estimated at £444m, ongoing costs are estimated at £127m.

We are particularly concerned about the impact of the administrative burden on smaller employers because:

- There is a potentially high regulatory burden on the smallest employers. Very few of these smaller employers are currently providing workplace pensions and will not have experience of providing pension or the processes involved; there are fixed cost elements of meeting the new duties; and these employers are less likely to have a specific HR resource and are therefore more like to carry the administrative burden themselves, potentially creating a conflict with their focus on running their business successfully.
- While the vast majority of employers are small employers, they employ a relatively small proportion of total employees. Of the 19.2 million private sector employees, 2.3 million work for micro employers and around 300,000 work for single employee firms. This raises the question of whether the regulatory burden, in conjunction with the costs of ensuring compliance, are proportionate to the benefits generated.

As a consequence, we have considered the burden on smaller employers carefully: Section 3.5 looks further at the extent of regulatory burden in the context of the level of pension contributions generated; Chapters 5 and 8 examine whether smaller employers should be covered by new requirements; and Chapter 6 looks at how the regulatory burden on employers and particularly small employers might be eased.

Table 3.4: Year 1 administrative costs split by firm size and activity (£m)

	Employer size *number of employees*						
Activity	**250+**	**50-249**	**20-49**	**5-19**	**2-4**	**1**	**Total**
Prepare for start-up	38	38	15	74	68	24	257
Registration	0	1	1	3	9	2	15
Enrolment	34	11	8	12	9	3	76
Collection and Administration	5	7	8	26	37	12	96
Total	**77**	**57**	**32**	**114**	**123**	**41**	**444**

Source: Department for Work and Pensions modelling.

Table 3.5: Ongoing administrative costs split by firm size and activity (£m)

	Employer size *number of employees*						
Activity	**250+**	**50-249**	**20-49**	**5-19**	**2-4**	**1**	**Total**
Prepare for start-up	0	0	2	0	6	2	10
Registration	0	0	0	0	2	0	3
Enrolment	7	3	2	3	3	1	18
Collection and Administration	5	7	8	26	37	12	96
Total	**11**	**10**	**12**	**30**	**47**	**16**	**127**

Source: Department for Work and Pensions modelling.

Table 3.6: Administrative costs per person automatically enrolled split by firm size

	Employer size *number of employees*						
Costs	**250+**	**50-249**	**20-49**	**5-19**	**2-4**	**1**	**Total**
Number of Individuals enrolled	4,149	1,713	1,162	1,891	1,055	296	10,266
Year 1 £	19	33	27	61	116	140	43
Ongoing £ *per year*	3	6	10	16	45	53	12

Source: Department for Work and Pensions modelling.

3.4 Contribution costs for employers

3.4.1 Stakeholder views

Most employers accept the Pensions Commission case for the role of an employer contribution in addressing the problem of undersaving for retirement. DWP's research in 2006 reported that six in ten employers felt that a minimum employer contribution was a good idea[45] and, in the Association of Consulting Actuaries' 2010 survey of small and medium sized firms, less than two in ten respondents felt that the employer contribution should be reduced, with a quarter thinking the levels should be increased[46].

45 Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, "Employer attitudes to personal accounts: Report of a quantitative survey", DWP Research Report No 397.

46 ACA, 2010, "Survey of smaller firms views on automatic enrolment and NEST."

3.4.2 Estimating contribution costs

Table 3.8 shows the additional costs needed to ensure all qualifying individuals receive the minimum three per cent employer contributions into their pension[47]. These figures represent the amount that employers will have to contribute to their employees' pensions, excluding their existing contributions bill for any pension provision they may have already. Thus, this takes account of any increase in contribution rates and increases in take up rate due to automatic enrolment.

One might have expected the contribution costs to be close to three per cent of labour costs. However, on closer inspection this is not so. First, these figures exclude the cost of existing pension contributions – a substantial proportion of employees are already members of a pension scheme and so there is no increase in costs for those jobholders. Second, the employer contribution is based on a band of earnings, whereas labour costs include all pay plus social security contributions. Finally, these figures are based on an assumption that around a quarter of employees will opt out of workplace pension saving once automatically enrolled. These three factors combine to produce the relatively low labour cost estimates seen in Table 3.7.

Table 3.7: Additional estimated costs to employers of minimum contributions, once contributions have been fully phased in

Number of employees	Contribution cost estimate *£m*	Percentage of labour cost *percentage*
1	80	0.8
2 to 4	310	
5 to 19	580	0.8
20 to 49	440	
50 to 249	590	0.6
250 to 499	230	0.4
500+	1,020	
Total	**3,240**	**0.5**

Source: Department for Work and Pensions modelling.

3.4.3 How employers plan to absorb costs associated with pension reform

Contribution costs represent an additional labour cost to employers. In the long term, we would expect this to be reflected in lower general wages than might otherwise have been the case. This would mean that individuals who choose to opt out of pension saving would be comparatively worse off, since their lower wages are not compensated by the three per cent employer pension contribution.

47 The costs are based upon the current UK pension landscape, which describes current pension provision and those individuals who will be automatically enrolled as a result of the reforms. The landscape is generated using: the Employer Pension Provision Survey 2009; the Annual Survey of Hours and Earnings 2009; the Employer Attitudes Survey 2007; and the Individual Attitude Survey 2009.

It is less clear in the short-term what employers will do to cope with contribution costs. This will largely depend on the anticipated scale of the additional costs. Employers who already contribute three per cent or more and have high levels of take up will face proportionally very low additional costs, since automatic enrolment will not increase the number of members by very much. By contrast, employers who make no contributions currently or have very low levels of take up will have to start paying contributions for a large proportion of their workforce for the first time, incurring much higher proportional costs. The options they have available to them for coping with these costs will depend on a number of other factors:

- The prevalence of existing pension provision, reducing the additional administrative and automatic enrolment costs on the reform.
- The ability of firms to be able to pass costs on to employees through lower wage settlements. Firms with a more elastic labour supply curve will find it easier to pass on costs through lower wages than those with a rigid labour supply and therefore face less pressure from the reforms.
- The ability of firms to pass on the costs to consumers through higher prices.
- The ability of firms to absorb the costs into their profit functions.
- The ability of firms to manage the costs of reforms through increased sales.

When asked in a 2009 DWP survey[48], three in ten employers (31 per cent) said they planned to absorb costs through profits/overheads, compared with two in ten (18 per cent) through wages and fifteen per cent through increased pricing. A further sixteen per cent felt they would have to reduce or restructure their workforce in order to counter the costs of the reforms. Employers' proposed strategies were based on considerations of complex trade-offs around competition, how highly unionised their workforce was, financial margins and pressure from shareholders to maintain profits. Underpinning all of this, employers felt that the economic climate and state of the labour market at the time would significantly affect their decision making. Ultimately, we will only know the extent to which employers used differing strategies by monitoring and evaluation of actual behaviours[49].

3.4.4 "Levelling down"

An alternative strategy for employers with existing high quality provision is to reduce their pension contributions across the board to offset the costs of higher membership resulting from automatic enrolment. Alternatively, employers may take the less drastic route of maintaining existing members' contributions, but offering only the minimum required to new members at the point of automatic enrolment. Workforce churn over time, combined with such a policy, would mean that an increasing proportion of individuals saving in workplace schemes would receive only a three per cent contribution from their employer. This risk of "levelling down" has consistently been raised as a concern by consumer groups and by the pensions industry.

48 Source: Bewley, H and Forth, J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

49 Treadwell, L and Thomas, A, 2008, "Understanding employers' responses to the workplace pension reforms: Report of a qualitative study", Department for Work and Pensions Research Report No 547.

We cannot know for certain how likely this might be, since a range of factors will influence employers' decision-making. It is difficult to predict any type of future behaviour, but nevertheless a wide range of interested parties, including DWP, have carried out surveys in an attempt to predict the likely extent of levelling down of existing pension provision[50].

Some of the earliest research evidence bears out the general pessimism: the Association of Consulting Actuaries reported that seven in ten employers expect there to be widespread levelling down[51], and Deloitte's modelling predicted eight in ten employers would level down[52]. However, taken as a whole, the bulk of evidence suggests only limited reductions in pension contributions as a result of the reforms. Surveys by Fidelity[53], Capita Hartshead[54] and the CBI[55] consistently report that around seven in ten employers are not planning to revise or reduce their current levels of provision, and the National Association of Pension Funds found only three per cent of employers planning to reduce contributions for existing members[56]. DWP's systematic survey of UK employers in 2009 reported that more than nine in ten employers already contributing three per cent or more plan to maintain or increase these contributions for current members, and eight in ten plan to extend their existing provision to new members[57]. The Association of Consulting Actuaries' 2010 survey of small and medium sized employers was slightly more pessimistic, with three in ten respondents indicating they were likely or highly likely to review their existing benefits, albeit only 11 per cent explicitly said they would level down their existing provision as a direct result of automatic enrolment[58].

From a purely economic standpoint, this is surprising. However, the majority of employers offering high quality pension provision are ideologically committed to maintaining this, either for paternalistic reasons, or as a crucial tool in recruiting and retaining employees. And whilst we should be cautious in interpreting how far stated intentions will translate into real behaviour, what little evidence there is generally suggests a reasonable degree of correlation between employers' given views and their actions[59]. At the same time, employers' stated preference for maintaining their pension provision will be tempered by pragmatic considerations of economic circumstances at the time and the feasibility of absorbing costs in other ways[60].

50 These surveys use a variety of methods, ranging from quick online surveys of a handful of an organisation's members to large-scale systematic sampling of the full employer population. Equally, the types of questions asked and the respondent's levels of understanding of the reforms varied widely. We must thus bear in mind the range in survey reliability and validity when interpreting the findings.

51 ACA, 2007, "Pension trends survey report."

52 Deloitte, 2006: "Pension reform in the workplace."

53 Fidelity research, 2008: "Corporate Commitment to Pension Provision."

54 Capita Hartshead, 2008: "Fifteenth Annual Pension Scheme Administration Survey."

55 CBI, 2009: "A view from the top: The 2009 CBI pensions survey."

56 NAPF, 2008: "Workplace Pensions: The Personnel Perspective."

57 Bewley, H and Forth, J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

58 ACA, 2010: "Survey of smaller firms views on automatic enrolment and NEST."

59 Hayward, B, Fong, B and Thornton, A, "The Third Work-Life Balance Employer Survey", Department for Business Enterprise and Regulatory Reform, Employment Relations Research Series No 86. This survey explored relationships between employers' attitudes to work/life balance and the degree to which they had implemented flexible working practices for employees.

60 Tredwell, L and Thomas, A, 2008, "Understanding employers' likely responses to the workplace pension reforms 2007: Report of a qualitative study", DWP report number 547.

A second risk factor for possible "levelling down" is the uncertainty created by the new definition of qualifying earnings, since this does not align with current definitions of pensionable pay. Employers who are unsure whether their existing arrangements are equivalent to the definition of qualifying earnings (eight per cent total contributions on a band of total earnings) may simply decide to re-calculate their contributions based on the minimum qualifying earnings requirements, to be certain they are meeting the duty for all employees. This would entail a calculation based on a lower level of earnings for some 90% of employees. We are uncertain how significant this risk is, but a simple certification model should help mitigate against this.

3.5 Ensuring employer compliance with the reforms

In addition to the direct costs to business of contributions and administration, one of the key costs associated with the reforms is the cost of ensuring compliance with the new duties. The benefit to individuals of automatic enrolment is directly dependent upon employers meeting their duties. Given that these duties are new to all employers, and that many employers will be providing pensions for the first time, an effective compliance regime is essential.

The greatest risk to the compliance regime is that large numbers of micro employers will fail to meet their duties, either through poor understanding of the duties or through wilful non-compliance. The smallest employers are identifiably at the highest risk of non-compliance, looking at their attitudes to pension provision, levels of understanding and self-reported risk of failing to meet the duties on time. This potentially presents a significant concern, given the very large numbers of very small employers, and thus the potentially high costs of following up and enforcing compliance with this group.

3.5.1 The role of The Pensions Regulator

The Pensions Regulator will have a new role in ensuring compliance with the automatic enrolment regime. The precise details of how The Pensions Regulator will apply enforcement will be subject to their discretion at the time, within their powers. However, the overall compliance approach is to educate employers about their responsibilities and encourage and assist them to comply with the legislative requirements. Enforcement, where necessary, will proceed from initial reminders through formal notices to penalties.

In the first instance, The Pensions Regulator will produce guidance for employers, many of whom will have no previous experience of pension provision, on how to comply with their new duties. It will also write to employers twice in the run-up to the employer's staging date, alerting them to the need to take appropriate action in good time. The Pensions Regulator will provide an on-line registration service for employers, process registrations, deal with queries relating to registration, and identify and pursue employers who have failed to register.

The Pensions Regulator will take a graduated, proportionate and risk-based approach to enforcement. It will investigate complaints from jobholders, scheme members, and trustees and administrators of pension schemes, making initial telephone or written contact with non-compliant employers, issuing compliance notices and, where necessary, proceeding to impose fixed and/or escalating penalties. The Pensions Regulator has the power, where appropriate, to inspect premises and require production of documents relevant to its investigations. It can institute criminal proceedings in the case of serious and persistent non-compliance. Once the reforms are established, The Pensions Regulator will consider carrying out pro-active checks to check compliance across employer sectors.

3.6 Evaluating the regulatory burden

The overall cost of the reforms relating to employers comprise three elements: the administrative burden on employers of complying with the reforms, the cost to The Pensions Regulator of enforcing employer compliance and the cost of NEST to ensure all employers have access to a suitable workplace pension scheme.

Table 3.8 compares the total of these costs with the estimated level of pension contributions generated as a result of the reforms. The total additional pension contributions across all employers over the implementation period are estimated to be £17,110m, while the total costs associated with administering this additional saving is £1,600m, or around 9 per cent of contribution costs. In steady state (2018/19), additional pension contributions are estimated to be £11,400m a year, while the total cost associated with administering additional saving is £250m a year, or around two per cent of contribution costs.

For micro employers, however, additional pension contributions over the implementation period are estimated to be £1,670m and the cost associated with administering this additional saving is £530m, or around 32 per cent. In steady state (2018/19), additional pension contributions are estimated to be £1,350m a year. The cost associated with administering this additional saving is £130m a year, or around 10 per cent. This confirms our concerns about the impact and proportionality of the administrative costs of applying the new duties to smaller employers, a theme we explore further in Chapters 5, 6 and 8.

Table 3.8: Pension contributions and total costs by firm size

	During implementation (total costs up to 2018/19)		In steady state (annual costs from 2018/19)	
	All employers	Micro firms	All employers	Micro firms
Total pension contributions *£m*	17,110	1,670	11,400	1,350
Total administration, NEST, compliance *£m*	1,600	530	250	130
Percentage	9	32	2	10

Source: Department for Work and Pensions modelling.

In evaluating the regulatory burden of the pension reforms, it is important to consider the context of the full range of regulations imposed by Government on business, to examine the cumulative impact for employers. These may affect their ability to cope with the burdens through further cost increases. Wage freezes due to low inflation, other new burdens for businesses alongside the current economic climate may make it difficult for firms to pass on the costs of these reforms as easily as they otherwise could. The Government is currently reviewing all legislation inherited from the previous Government that has not yet been implemented. Until these regulations have been reviewed, it is not possible to say what other regulations will be implemented between now and 2012.

3.7 Conclusions

Most employers accept the Pensions Commission case for the need to address under-saving for retirement and recognise the role of an employer contribution in pension reform. Employers are more critical of the costs associated with the administrative processes required under pension reform. We want to minimise the administrative costs as far as possible, and ensure that they are proportionate to the benefits of automatic enrolment in terms of the additional pension saving generated, particularly for micro employers who represent 66 per cent of all employers but employ only 12 per cent of the workforce.

We can divide employers into five broad groups, based on the degree of change they will have to make to their existing pension arrangements in response to the reforms. The first two of these five groups of employers will face the least change because they already provide good quality workplace pensions. They are familiar with making decisions about pension provision, and can be confident that they already contribute enough to meet minimum quality requirements. The other three groups of employers have no or limited experience of pension provision. Where they do provide a pension, it may not meet the quality requirements under the reform.

Costs to employers can be divided into two portions. The contribution costs are the costs to the employer of providing the three per cent minimum contribution to members; this represents a transfer to the employee, rather than a pure cost in economic terms. By contrast, administrative costs are the cost to the employer of setting up a pension scheme, automatically enrolling employees, calculating and deducting contributions, and registering with the Pensions Regulator. These costs represent a true economic cost, and it is these costs that we are keen to minimise as far as possible.

We pick up these themes further in Chapters 5, 6 and 8.

The role for NEST in the pensions market under automatic enrolment 4

Summary

This chapter considers whether an intervention like NEST is necessary to support the introduction of automatic enrolment.

We start with the presumption that the scope for automatic enrolment remains broadly in line with that proposed by the Pensions Commission and examine what drives profitability in the existing pension market and how automatic enrolment will impact on profitability. This analysis supports the Pensions Commission's argument that there is a supply gap in the existing pensions market and that this gap persists despite the introduction of automatic enrolment. In fact, automatic enrolment counter-intuitively decreases overall profitability in the market, due to the inclusion of new savers with low salaries, low contribution levels and relatively high job churn.

In this chapter we look at a range of options to fill the supply gap within the current scope, including ensuring universal coverage through subsidising pension providers or putting administrative arrangements in place to reduce costs for providers. In Chapter 7, we go on to consider whether changes in the scope of the reforms can reduce this supply gap.

Some stakeholders suggested alternative models that would use more of the existing industry infrastructure than NEST, typically by creating a new government funded front end to handle member joining and contribution collection, but utilising existing infrastructure to manage member accounts. Whilst we have seen nothing to suggest that these models could not succeed at lower build costs than NEST, we have seen no proof of concept. A key factor in drawing our conclusions on such options was timing. The Pensions Commission set out the basic choice the nation faces: save more or work longer or pay higher taxes. They saw the "save more" option as critical to ensure the large "baby boomer" generation save now for their own retirement, rather than asking the smaller generations that follow to pay for them through taxation. Probably inevitably, the programme has already taken longer to implement than the Pensions Commission envisaged, but to delay it further, maybe by up to another three years, while alternative models are investigated and built, would be problematic.

While we would be naturally cautious of recommending such a major intervention into the market, supported by a government loan, as NEST, we see no alternative if automatic enrolment is to be introduced at anything like the currently envisaged scope on anything like the currently envisaged timescale.

4.1 Introduction

There are currently around 56 thousand private sector occupational pension schemes in the UK. Twenty insurers hold the vast majority of this business, both in terms of policies and assets under management[61]. Nevertheless, pension coverage has reduced among private sector employees, standing at only 37 per cent in 2009. Around 6.5m people save into non-employer sponsored schemes. Automatic enrolment is intended to encourage more people to save for retirement. Following the introduction of workplace pension reforms in 2012, the DWP estimates that around 5 to 9 million people will be newly saving or saving more for retirement.

For automatic enrolment to succeed, every employer and individual must be able to access pension saving. However, the Pensions Commission's analysis concluded that there will be a significant number of companies or individuals who are unprofitable for the pensions market to serve at a reasonable cost to members, typically small companies and lower earners. This being the case, automatic enrolment would be unworkable. The Pension Commission's solution to this was the National Pension Savings Scheme (now NEST).

This Chapter is designed to ask whether NEST is necessary. This is important, first because it is initially funded by a government loan and, second, because it will inevitably have some effect on competition in the market. We therefore look at what the private sector can profitably do, and at other potential supply models for automatic enrolment.

Section 4.2 discusses the supply gap in the current pensions market. Section 4.3 then examines the impact of introducing automatic enrolment on profitability. Section 4.4 looks briefly at stakeholder pension schemes. Section 4.5 examines the lessons from international experience and the Pensions Commission's rationale in recommending a National Pension Savings Scheme. Section 4.6 looks at alternative ways of filling the supply gap.

4.2 The supply gap in the pensions market

The planned introduction of NEST into the pensions market is predicated on the assumption that it would not be profitable for the existing pensions industry to service certain segments of the market at an acceptable cost to members. For the purpose of our analysis, we have adopted a benchmark for acceptability of the typical levels of charges enjoyed by today's pension savers, with an absolute upper bound of the stakeholder charge cap of 1.5 per cent for the first ten years and 1.0 per cent thereafter.

4.2.1 The Pensions Commission's conclusions

Profitability in the pensions market depends on the balance between the cost to the provider in setting up and running the scheme, and the revenues received. Planning horizons are also a crucial factor. For example, whether a firm will be profitable for a provider in 5, 10, 20 or 40 years will influence their willingness to supply.

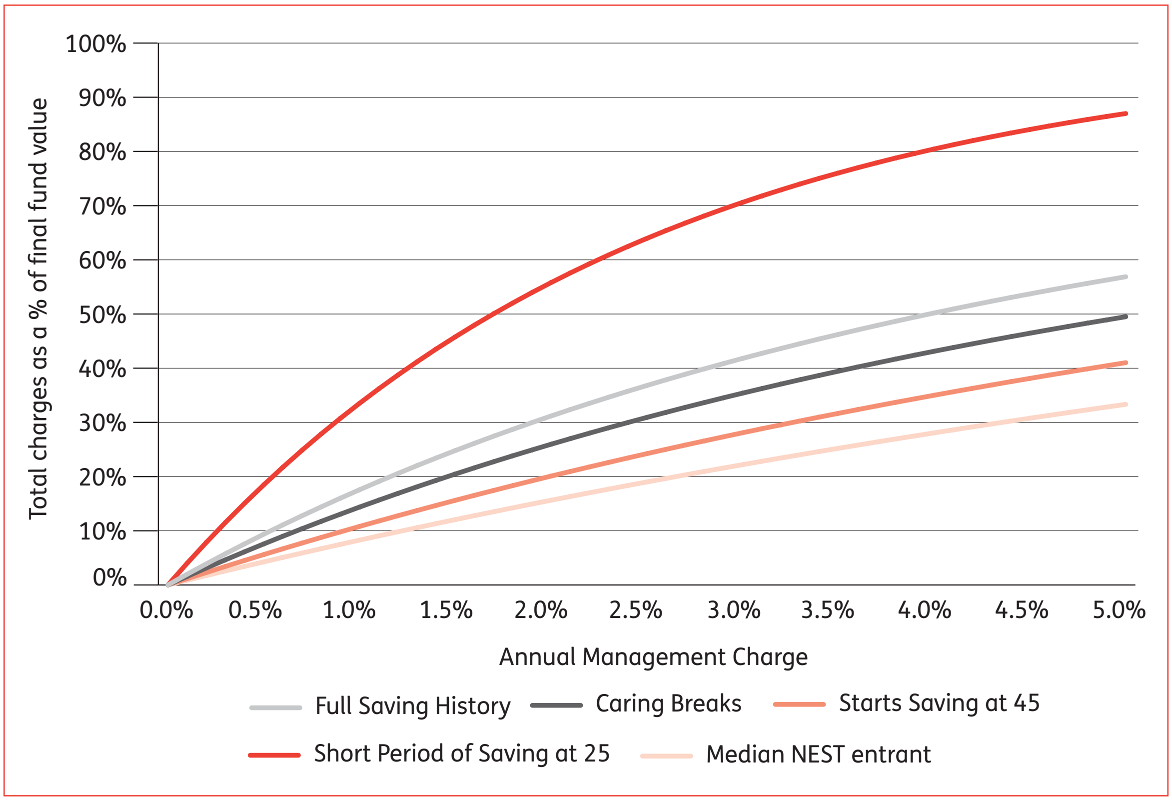
61 ABI, 2009, Money in Funded Pensions in 2008.

Revenues come from charges, typically on funds under management via an annual management charge (AMC) but also to a lesser extent on contributions via contribution charges (CC). The amount of revenue received depends on the amount contributed into the scheme, which in turn depends on the number of members, their salary levels and contribution rates. Schemes with low member turnover, and hence high proportions of active to inactive members, also tend to be more profitable (see Section 4.3).

Where a scheme is not predicted to be very profitable, the insurer will tend to charge at a higher rate to ensure that they are able to recoup the costs of setting up and running the scheme. However, the Pensions Commission argued that there is a supply gap in the pensions market. Even under the stakeholder charge cap of 1.5/1.0 per cent annual management charge, significant numbers of median earners working in small and medium sized firms are unprofitable or only marginally profitable for the pensions market.

Furthermore, the Pensions Commission argued that to achieve good member outcomes charge levels should be much lower than 1.5/1.0 per cent. Charge levels have a significant impact on lifetime savings. Chart 4.1 shows that a median earner with a full savings history who pays a 0.5 per cent AMC would lose nine per cent of their total fund value. By contrast, at the 2.5 per cent level, the saver would lose 37 per cent of their funds. Even at the stakeholder charge cap, a median earner with a full savings history will lose over 20 per cent of their total fund value.

Chart 4.1 Total charges as a percentage of final fund value



Source: Department for Work and Pensions modelling.

To address the supply gap whilst achieving good member outcomes, the Pensions Commission therefore recommended the creation of a low-charge national pension savings scheme (now NEST). Based on examples of costs in UK occupational pension schemes, and international comparisons such as the Swedish Premium Pension Scheme[62], the Pensions Commission proposed that an AMC of 0.3 per cent should be achievable, due to two key factors: reduced costs and greater persistency. The Pensions Commission envisaged a reform environment in which all eligible workers without current workplace pensions are automatically enrolled into the national pension savings scheme (or branded-provider model equivalent). This would reduce the need for marketing and advertising to attract members, would eliminate the need for regulated advice, and would ensure economies of scale in the scheme, significantly reducing costs. Under this system, the Pensions Commission also assumed that the majority of individuals enrolled into the national pension savings scheme would end up saving into this (rather than individual employer schemes) for the majority of their saving life. This very high persistency would dramatically reduce the costs associated with administering inactive pension pots.

4.2.2 Changes since the Pensions Commission's recommendations

The pensions landscape has altered significantly since the Pensions Commission reported, partly but not wholly due to the economic downturn:

- The Government Actuary's Department forecasts of longevity show further increases in life expectancy since the Pensions Commission's report.
- Pension coverage has reduced amongst private sector employees, falling from 42 per cent in 2005 to 37 per cent in 2009, and from 7.9 million savers in 2005 to 7.0 million in 2009. This includes a million fewer members of defined benefit schemes (down from 3.8 million to 2.8 million) which is not offset by the small increase in defined contribution/group personal pensions or stakeholder pensions (up from 4.0 million to 4.1 million)[63]. The proportion of employers offering any workplace based pension scheme fell from 33 per cent in 2007 to 27 per cent in 2009[64]. This was characterised by a reduction in the proportion of employers who offer an occupational scheme and a reduction in the proportion of employers who offer a workplace stakeholder pension.
- The economic downturn was initially associated with a fall in equity returns, but there was then a strong recovery, such that many pension investment funds have fully recovered the losses from the early part of the downturn.
- The FSA launched the Retail Distribution Review (RDR) in 2006. It is currently in a consultation phase. The review is very broad and aims to address persistent problems in the retail investment market. In its latest consultation paper, the RDR proposes a ban on commission in the sale of personal pensions, including group personal pensions and a move to a fee-based system where employers will need to arrange to pay an upfront fee to an adviser (consultancy-based fees). The reason for this proposal is to make charges more transparent to employees and remove commission bias from the sale of contract based pension schemes.

62 OPSS (GAD) 1998 shows occupational schemes with 5000+ members operating at average costs far below 0.3 per cent; The Swedish system operates at 0.37 per cent for default fund investors, and 0.64 per cent for others, envisaged to fall below 0.2 per cent and to 0.33 per cent respectively by 2020.

63 Annual Survey of Hours and Earnings, United Kingdom 2005 – 2009, Office for National Statistics.

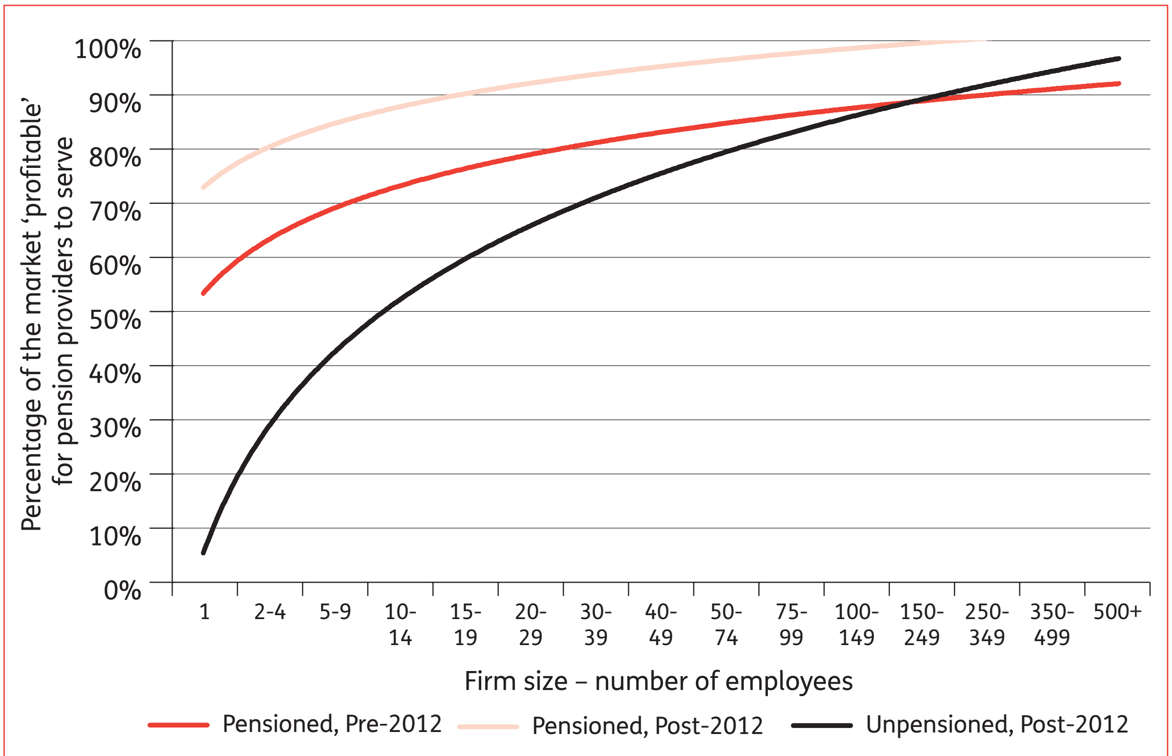
64 Forth, J and Stokes, L, 2010, "Employers' Pension Provision Survey 2009", Department for Work and Pensions Research Report No 687.

4.3 How will automatic enrolment affect profitability in the market?

Automatic enrolment is intended to solve the problem of low pension take-up and increase both the numbers of people saving for retirement and the average rates of contributions. As a consequence, it is expected to increase overall pension contributions without significant effort on the part of providers, so companies will reap higher revenues without equivalent marketing costs. One might therefore have expected profitability across the market to increase after the introduction of automatic enrolment, reducing the supply gap.

However, DWP modelling shows that this is not necessarily the case. Chart 4.2 shows that employers who currently have pension schemes are highly profitable to the pension provider, as you would expect. After 2012, these firms become more profitable. However, firms that will offer provision for the first time after 2012 are much less profitable than those firms that already had provision. Even at the relatively high charge levels shown in the chart, less than half of previously unpensioned firms with ten employees or fewer will be profitable. If the charges are reduced, the difference becomes even more pronounced (see Chart C.3.1.1 in Annex C).

Chart 4.2 Profitability of firms before and after the introduction of automatic enrolment, under Stakeholder Charge Cap



Source: Department for Work and Pensions modelling.

In order to understand these results, we have examined the different factors that influence profitability. This next section discusses cost and revenue drivers in the pensions market and presents modelling which explores the different factors influencing profitability. The discussion and analysis presented is at scheme level[65].

4.3.1 Costs

Pension providers incur costs through the following activities:

- Selling the scheme to the employer.
- Setting up a scheme: smaller schemes are typically more expensive because the same fixed cost must be borne by fewer members.
- Marketing the scheme to members: costs are lower where employers facilitate joining mechanisms like automatic enrolment or streamlined joining processes, so reducing providers efforts to 'persuade' employees to join the scheme; incentives like employer contributions to the scheme also make a difference.
- Enrolling each individual in the scheme: although smaller than the costs above, these are still relevant, since a member who makes low or no contributions to their fund will represent a net cost to the scheme provider.
- Maintaining each fund: this will vary and is generally low, but in cases where members are difficult to contact, for example if they move abroad without leaving a forwarding address, costs can quickly escalate when providers require decisions on, for example, how to vest the fund.
- Processing members who leave the scheme.

4.3.2 Revenues from charges

These costs are typically recovered from revenues generated through the levying of charges, typically on funds under management (AMCs) but also to a lesser extent on contributions (CCs). Some employers meet some or all of the charges on their scheme independent of members' funds or contributions.

The size of the revenues generated from charges depends upon a number of factors:

- Number of members in the scheme; larger numbers allow the provider to distribute the fixed costs.
- Members' average salaries.
- Contribution rates (from members and the employer).
- How long members contribute for: providers are more likely to recover costs on savers who contribute significant amounts throughout the life of a fund, or concentrate contributions early, than on those who defer savings until late in the fund's life, even if contributing large amounts at this time.

65 One important caveat is that profitability is not black and white for pension providers. A provider may look at profitability across its whole book rather than on a scheme only basis. Some schemes or firms may in isolation be unprofitable but providers take on the business for other reasons, for example as a halo brand to attract future business.

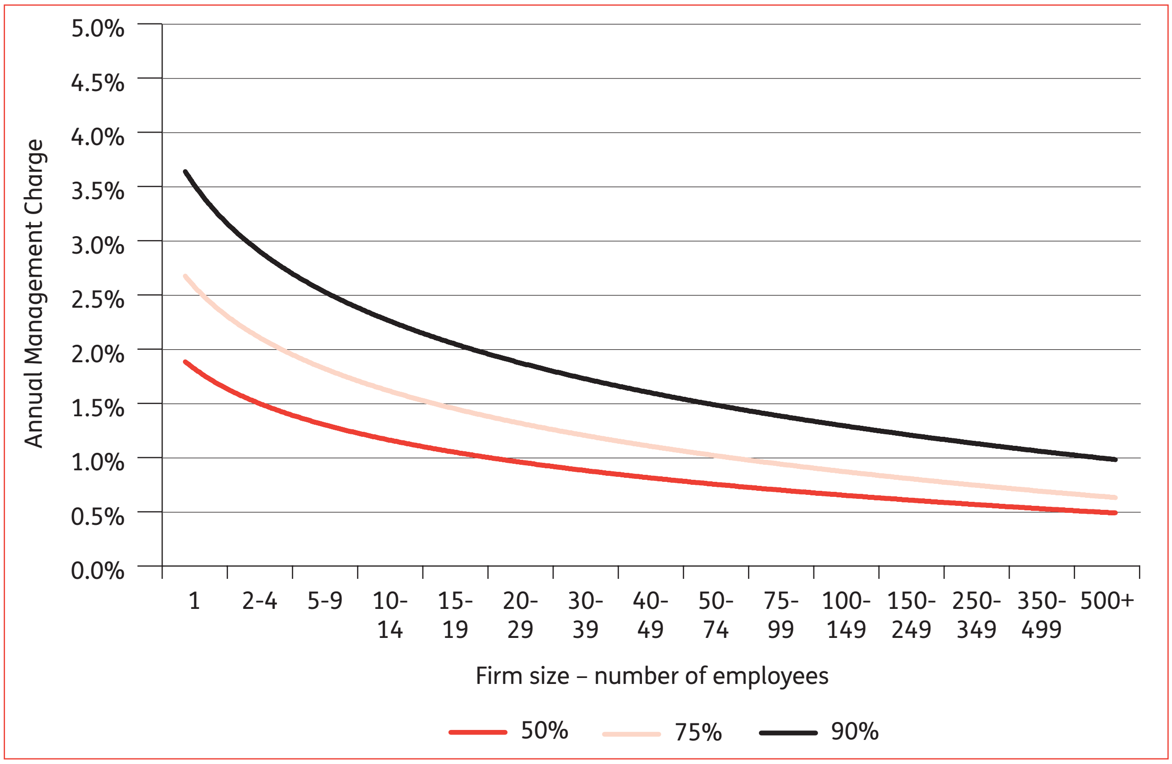
Schemes where contributions are expected to be relatively low will be sold at higher charge levels to ensure the provider is able to recoup the costs of selling, setting up and running the scheme. Currently, providers selling workplace personal pensions argue that the introduction of the stakeholder pension charging cap has forced down prices across the market and that there is a de facto universal limit of an annual management charge (AMC) of 1.5 per cent[66]. A survey in 2009 found that charges in contract-based workplace personal pensions tend to be around a 0.4 – 0.59 per cent AMC excluding commission, or around one per cent where commission is paid to an intermediary. The majority of trust-based occupational pensions also tend to have a single overall charge, in the region of one per cent of funds, though some schemes use contribution charges or a combination of AMCs and CCs instead. However, in three out of four trust-based schemes, the employer pays some or all of the charges, rather than members[67].

In deciding whether or not to take on business, and then on the charge levels for that business, a provider will consider the balance between the costs and the expected revenues, taking into account the timespan for recouping costs. Providers say that they try to find out information about an employer's workforce, for example size, age, turnover, salary, in order to inform this decision as far as possible. There are few firms that could not in theory be profitably served by the pensions market, but there are many firms for whom the charge levels needed to recover costs would be unacceptably high. It would seriously undermine the Pensions Commission's carefully crafted settlement of boosting employee savings with compulsory employer contributions if the benefit of the employer matching was effectively lost to exorbitant charges. When charge levels become so high, individuals might even respond by saving elsewhere (for example in ISAs) or not saving at all, at which point the revenue base recedes, necessitating higher charge levels and the market for this group collapses.

Chart 4.3 shows the charge levels necessary to make different percentiles of the employer market (by firm size) profitable after the introduction of automatic enrolment. For example, in order for three-quarters of micro employers to be profitable, providers would have to charge an AMC over 2 per cent.

66 Wood, A, Leston, J and Robertson, M, 2009, "Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries", Department for Work and Pensions Research Report No 591.
67 Source: Croll, A, Vargeson, E and Lewis, A, 2010, "Charging levels and structures in Money purchase pension schemes: Report of a quantitative survey", Department for Work and Pensions Research Report No 630.

Chart 4.3 AMCs required to make 50 per cent, 75 per cent or 90 per cent of the market profitable



Source: Department for Work and Pensions modelling.

4.3.3 Analysis of key factors determining how 'profitable' schemes are

Some key characteristics of employers and their workforce will determine scheme profitability. Annex C.3 presents new DWP modelling of profitability, with the following key findings.

- A very strong positive association between employer size and the likelihood that a company scheme will be profitable. Around three quarters of employers who have 20-29 employees would be profitable at the stakeholder charge cap, compared with only around one quarter of employers who have 2 employees.
- A very strong relationship between average pay and profitability. Employers who offer an average salary below £18,000 a year are very rarely profitable to pension providers.
- A clear relationship between job churn (in terms of the number of individuals leaving an employer per year) and profitability. Just under half of employers with the lowest job churn are profitable, compared with less than ten per cent of the employers with the highest job churn.
- A strong relationship between current pension provision, with 91 per cent of employers who currently offer any kind of pension scheme to some of their employees expected to be profitable after automatic enrolment, compared to only 23 per cent of employers with no pension provision.

This modelling fits with pension providers' comments around the determinants of profitability, which highlighted member salary and job churn as being key factors[68].

4.3.4 Understanding the impact of automatic enrolment on profitability

Chart 4.2 showed that introducing automatic enrolment makes previously pensioned employers more profitable, but that many previously unpensioned firms remain highly unprofitable. There are two opposing influences on this outcome. Firstly, automatic enrolment causes participation in pension schemes to increase significantly. Chapter 3 suggests that membership might rise from around a third on average to three-quarters or even higher, without corresponding marketing costs to persuade individuals to join. This will increase revenues overall and increase the number of members over which the fixed costs can be spread.

However, this is countered by the second effect, which relates to the characteristics of members brought in through automatic enrolment. At the employer level, we know that the majority of unpensioned companies are micro employers. These employers tend to offer lower average salaries and experience higher employee churn than large firms (see Chapter 3). The analysis in Chapter 2 shows us, at the individual level, that those who have chosen to save into a pension tend to earn more than those who are not saving, are older, and thus can be expected to move jobs less frequently. Putting this together, we can see that the population of savers brought in by automatic enrolment is expected to be concentrated in small firms, to earn less and move jobs more frequently, and thus be less profitable than those already saving.

In addition, the introduction of a low-cost scheme such as NEST is expected to drive down management charges, and thus overall revenues. This effect will be less pronounced for existing schemes than for new ones, both because they are already likely to charge at a more competitive rate prior to the introduction of NEST and because a lower charge rate is needed to attract new customers than to retain existing ones. New members are also less likely than existing members to contribute more than the minimum required under the Pensions Act 2008, and are potentially more likely to opt out, generating higher administration costs for the pension provider.

These effects are illustrated by Chart 4.2, which compared the profitability of previously pensioned and unpensioned firms after the introduction of automatic enrolment. From the pensions industry's perspective this is potentially concerning, since the overwhelming majority of unpensioned employers have fewer than fifteen employees.

This analysis chimes with the views expressed by pension providers, who are not convinced that automatic enrolment will necessarily result in an overall increase in revenue or profitability. They argue that increases in numbers of members does not necessarily translate into significantly higher contributions overall, due to the low level of minimum contributions. Further, they are concerned that new revenues would be offset by the administrative burden of enrolling and un-enrolling high churn individuals with low salaries and contribution rates. Consequently, some providers feel that automatic enrolment may not lead to increased revenue, even in existing schemes [69].

68 Wood, A., Leston, J. and Robertson, M., 2009, "Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries" DWP report number 591.

69 Wood, Leston and Robertson, 2009, "Pensions industry responses to the workplace pension reforms: Qualitative research with pension providers and intermediaries", Department for Work and Pensions Research Report No 592.

4.4 Stakeholder pension schemes

Since 2001, employers with five or more relevant employees have had to offer a stakeholder pension scheme to their employees, or provide another scheme of equivalent or better quality. These schemes are bound by prescribed quality standards, including a charge cap of 1.5 per cent for the first ten years, thereafter moving to one per cent. The aim of this policy was to provide easy access to simple, low-cost pension schemes to low and middle income groups. The stakeholder charge cap was initially set at one per cent, and then later increased to 1.5 per cent for the first ten years and 1 per cent thereafter when distribution and regulatory costs in the stakeholder market turned out to be higher than expected.

There have been successes and failures with the stakeholder initiative. On the plus side, it has driven down charges and improved value to the customer, particularly amongst workplace defined contribution schemes and for individuals who make their own decision to save for retirement. But, despite quickly achieving over one million members, stakeholder schemes never achieved the level of uptake expected and created an advice gap in the pensions market. There have also been instances of small firms experiencing difficulty in finding a pension provider genuinely willing to serve them.

The advice gap, in particular, has meant that too many people are not saving for retirement, despite being offered access to simple, low cost stakeholder pension schemes. Financial capability amongst key groups of concern is relatively low[70], and simply informing people of the need to save, and ensuring they can find a suitable savings vehicle are not sufficient to make people act. For this reason, the Pensions Commission argued for the introduction of automatic enrolment to increase the numbers of people saving for retirement, as set out in Chapter 1.

4.5 Meeting the demand created by automatic enrolment: learning from other countries and history

We now turn to the question of how to meet the demand created by automatic enrolment, and whether the existing market, including stakeholder schemes, is able to cope.

Before our appraisal of possible options, in Section 4.5, we first examine what we can learn both from international experience of pension reform and from earlier decisions in relation to reform in the UK.

4.5.1 International experience

A number of countries have implemented private pension reform, but there is no single perfect comparator to UK workplace pension reforms. New Zealand, Australia and Sweden bear most comparison to components of UK reform[71].

70 Atkinson, McKay, Kempson and Collard, 2006, "Levels of Financial Capability in the UK: Results of a Baseline Survey". Prepared for the Financial Services Authority by the Personal Finance Research Centre, University of Bristol.

71 Collard and Moore, 2010, "Review of International Pension Reforms", Department for Work and Pensions Research Report No 663.

The KiwiSaver scheme, introduced in New Zealand in 2007, provides the closest comparison to the UK workplace pension reforms. KiwiSaver schemes are provided by banks, insurance companies and fund management companies, who administer and manage members' savings. Fifty-two KiwiSaver schemes were on offer from 30 providers in 2009. Seventy-seven per cent of KiwiSaver membership and 78 per cent of KiwiSaver funds are held by nine schemes. Six of these are the default funds to which people are allocated if they are automatically enrolled and do not make an active choice or their employer has not nominated a scheme for them to join.

In Australia, the Superannuation Guarantee was introduced in 1992, which is a mandatory employer contribution to a private pension plan, which employers have to pay quarterly either directly to a regulated superannuation fund or via a commercially-operated clearing house. The plans may be operated by the employer, industry associations, financial services providers or by individuals themselves. At the end of September 2009, there were 457 superannuation funds for people to choose from in the four main fund categories (corporate, industry, retail and public sector). There were another 421,671 small funds with fewer than five members, most of which are self-managed.

In Sweden, a new pension system was introduced in 1999, which consisted of an earnings-related element based on a system of notional accounts, and a small mandatory contribution to the Premium Pension, a defined contribution pension scheme. There are approximately 85 companies involved in the Premium Pension market, providing over 700 separate funds.

Charging structures and their regulation vary internationally. There is no prescribed fee structure or level of fees for KiwiSaver pension plans in New Zealand, although the KiwiSaver legislation prevents providers charging 'unreasonable' fees. The fees charged by default fund providers were negotiated by the Government and prescribed for each provider in their Instrument of Appointment.

Superannuation accounts in Australia have fixed commission fees, fees on contributions and an asset management fee. While these are not capped, the regulatory rules prohibit any administrative fees that exceed investment returns being charged on accounts with a balance of less than AUD 1,000 (£500), except in periods of bad investment returns (i.e. a period where investment returns are less than administration costs).

In Sweden, Premium Pension plans attract an asset management fee, which is not capped. Sweden is considered to have relatively low fee levels, at less than 0.5 per cent of assets under management. This is largely due to the clearing house system operated by the Premium Pension Authority (which became part of the Pensions Authority), which negotiates management fees directly with providers. The Premium Pension Authority also operates a discount schedule, based on the principle that the marginal cost of investing additional funds decreases the greater the volume of Premium Pension assets invested. As the scale of business increased over time, therefore, the required fund discounts increased as well. As a result, the total costs are estimated to fall from 0.45 per cent of assets under management in 2007 to 0.23-0.27 per cent by 2020.

There is little evidence of the impact of private pension reform on the pensions industry and national pensions markets. There is some evidence of a concentration of provision among a small number of large providers, although whether this had impacted on competition was unclear. These are often the default funds and are characteristically conservative in their investment approach. Established providers with networks of offices and large sales forces have been able to increase market share, but at an increased cost to the pension saver. The results of evaluations in New Zealand in 2008 and early 2009 suggest that it is still too early to say with confidence what the effect has been.

There is no direct equivalent to the establishment of NEST internationally. The number of providers involved in delivering private pensions under reformed systems varies considerably, which leads to the question of why NEST has previously been considered to be necessary by the UK Government, when no such scheme exists elsewhere. We will look briefly at the history of this decision, before turning to stakeholder views and then examining other supply options in more detail.

4.5.2 Government history of model choice decision: National Pension Savings Scheme and provider choice models

In designing NEST, DWP considered and consulted on two main operational models (along with variations on these core approaches):

- National Pension Savings Scheme (NPSS) model: in this model, proposed by the Pensions Commission, the scheme would be administered by a single organisation which would manage and service members' accounts and interface with fund managers. Competition under this model would be for contracts, rather than individual members.

- Provider choice model: rather than a single organisation having oversight of the system, a limited number of branded pension providers would offer schemes and administer the accounts. Savers could choose their preferred provider or be allocated to a default provider.

It was assumed that both models would involve some initial cost to government, either in setting up the NPSS or in providing an administrative 'front end' for the provider carousel to collect and channel individuals' contributions appropriately.

Whilst no option perfectly fulfilled all the evaluation criteria, at the time the NPSS model was assessed by DWP as preferable on four key criteria:

- Coverage: the more limited choice prescribed by the NPSS model is more appropriate for consumers and thus more likely to maximise participation. Evidence shows that individuals commonly lack confidence with financial decision-making and can be deterred by too much choice.

- Rate of return: whilst set up and administration costs looked broadly similar across the models, DWP's analysis suggested that the provider choice model would be 20-25 per cent more expensive, due to the cost of marketing to individuals.

- Operational efficiency: the NPSS model is simpler for both employers and members, who only have to deal with one organisation.

- Risk: regulators have suggested that any approach delivered by branded providers is more likely to generate inappropriate business practices, since providers have financial incentives to act against members interests by, for example, competing aggressively to capture market share.

4.5.3 Stakeholder views after the Pensions Commission reported

At the time of the decision on delivery model, the only options under consideration were the NPSS or the branded provider choice model, or variations on these. Responses from the pensions industry supported the branded provider choice model (or variants), arguing that this model offers the opportunity to re-use existing infra-structural assets, and thus avoid unnecessary investment and help reduce implementation risk. Increased choice and personal responsibility were also cited as arguments for this model, along with the benefits of more efficient competition. By contrast, employer and worker representatives tended to support the NPSS model on grounds of lower costs, greater simplicity and better protection for members.

4.6 Meeting the demand created by automatic enrolment: our appraisal

The current proposed approach of establishing NEST would represent a significant intervention into an existing commercial market. We would only support such an intervention if:

- The existing market was unable to deliver the outcomes necessary to support the policy ambition of addressing the long-term pension savings deficit; and
- It was not possible to achieve those ambitions through a less interventionist market solution.

Earlier in this chapter, we considered the existing industry's profitability, how this might be affected by the introduction of automatic enrolment and the extent to which the pensions industry was able to meet the demand created by the current proposed scope for automatic enrolment. This analysis supports the Pensions Commission's conclusion that there is a "supply gap" as a result of the existing industry being unable to profitably supply a suitable low cost product to all employers seeking to automatically enrol their employees.

In Chapter 7, we go on to consider whether changes to the scope of automatic enrolment might support the pensions industry in supplying a suitable product to a greater proportion of the post automatic enrolment demand. Here, we draw conclusions on the breadth of scope of automatic enrolment that could be delivered without market intervention, and the circumstances in which a supply gap would remain.

In this section, we consider the various interventions that might be made, should the scope for automatic enrolment be such that a supply gap remains. This analysis allows us to consider how NEST might ensure such a supply gap is met and how it compares with alternative interventions. In doing so, we consider the impact of each option on individuals, employers, the pensions industry, costs to Government and programme delivery. We summarise what stakeholders have told us (Section 4.6.1) and assess the options we have identified to meet any supply gap in the pensions market, including NEST (Sections 4.6.2 to 4.6.8).

Any strategies to increase supply to meet the demand created by the current automatic enrolment policy must look to increase the profitability of the market, either through increasing revenue, or decreasing costs for pension providers, or both. However, we feel that the options should be constrained by a maximum charge level. Any system aimed at improving access to pension schemes for low and median earners that nevertheless allowed unlimited charges on members would fundamentally lack credibility, and would not be in the public interest, and we do not want to lose the advances in value for money that have been gained in the UK over the last ten years.

Overall, regardless of the charge structure, we feel that charge levels exceeding an equivalent to the current stakeholder charge cap would result in unacceptably poor outcomes for savers, and that, ideally, charges would be below even this level. Our analysis of supply options is therefore based in part on their ability to deliver acceptable charges, and our modelling is conducted on the basis that charges do not exceed a maximum of the stakeholder cap (1.5 per cent AMC, declining to 1 per cent after 10 years).

With NEST in the market, we would expect providers to compete with charges in the range 0.3 per cent to 1 per cent AMC equivalent. Qualitative research conducted by DWP in 2008 shows that providers do not typically expect the reforms and the introduction of NEST to impact upon the largest trust-based occupational pensions to any significant degree[72]. However, there is an expectation that the reforms (and NEST in particular) will have considerable impact on the workplace personal pension (WPP) market. NEST will provide competition at the small and medium employer end of the market. We believe that the more progressive pension providers will raise their game to meet the competition, to the benefit of the employees being automatically enrolled. Pension providers will tailor their response according to profitability, so the smallest and least attractive firms will probably find NEST offers them best value, whilst "higher-end" employers will benefit most as pension providers compete to secure them over NEST.

4.6.1 Stakeholder views now

As a part of this review process, we sought to consult with as many interested parties as possible, including holding seminars and individual meetings, and through a call for written responses. We asked specifically for ideas on how to meet demand in the pensions market.

The responses were generally in favour of retaining NEST, across consumer, employer and industry groups. Overall, NEST was seen as the best proposition for providing for low and middle income groups at a low cost, with the added benefit of diminishing the burden on employers of sourcing appropriate pension provision. Consumer groups, in particular, strongly preferred an independent not-for-profit body to manage any new pension scheme.

72 Wood, A, Leston, J and Robertson, M, 2009, "Pensions industry responses to the workplace pensions reforms", Department for Work and Pensions Research Report No 592.

The majority of stakeholders were also strongly in favour of retaining an October 2012 start to the implementation of the reforms. We regard this as particularly important in the light of the demographic situation. The large “baby boomer” generation need to save more for their own retirement otherwise the smaller generations that follow will have to pay higher taxes to provide for the baby boomers in retirement. Demographers generally define the baby boom generation as those born between 1945 and 1966, which means that the first baby boomers are already starting to retire. Any further delay to automatic enrolment could conflict with the Pensions Commission’s demographic argument. The current broad approach and timescales are backed by a broad consensus and already have a strong delivery momentum. Stakeholders see NEST as well advanced in its development and infrastructure, and feel it would not be possible to deliver alternative approaches in time to support implementation in the necessary timeframe. Discussions with Ministers have confirmed that they share a desire to make early progress in tackling the savings deficit. For these reasons, we have assessed supply options on their implications for the delivery of the reform programme, as well as their impact on individuals, employers and the pensions industry.

Further, there were very few suggestions that the pensions industry would be able to provide universal coverage for the target group under the terms of the Pensions Act 2008. There were some suggestions that the pensions industry might be able to meet demand if the scope of the target group was significantly changed, and some mentions of “well regulated master-trusts” as an option. However, even under an amended scope, low charge rates were seen as a deterrent, and it was felt that the pensions industry is not cohesive or united enough to provide a holistic pension solution to less attractive savers. Thus, apart from a few respondents, the general message was that the economics of the NEST proposition are not viable or attractive enough for the private pensions industry to be drawn in. Nevertheless, we have explored in Chapter 7 whether any combinations of options might render the market sufficiently attractive to providers to enable a wholly industry based supply solution under automatic enrolment.

4.6.2 Free market response: no systematic changes to current market

The least interventionist option would be to harness existing provision. Section 4.4 touched on the existing statutory duty on employers who have at least five relevant employees to designate a group stakeholder scheme for their workforce. Stakeholder schemes could be seen as an appropriate pension savings medium for low to median earners under automatic enrolment.

Coverage and costs to individuals

Despite the reduced selling costs and greater take up rates associated with automatic enrolment, it would not be profitable for providers to sell to all companies or individuals at charge levels around the stakeholder cap. The DWP’s profitability analysis shows that less than half of all micro employers would be profitable at this level. Micro employers comprise nearly seven in ten of all employers, covering 12 per cent of the total workforce. Thus it is likely that, under a free market option, around 800,000 employers would find it difficult to access pension provision, affecting 2.3 million workers.

The present programme solution to the supply gap is to impose a public service obligation on NEST forcing it to take all-comers, however unprofitable. Attempting to apply a public service obligation to the whole pensions market would not be a viable option. The pensions industry would undoubtedly object very strongly, and any attempt to enshrine such a move in legislation would be difficult and likely to attract judicial review. A universal public service obligation could significantly distort competition in the market, as smaller and niche providers would eventually be forced out, leaving a handful of the largest companies to share the market. Even the larger providers may be disadvantaged if they are selected disproportionately by unprofitable employers, and could struggle to ensure their business remains viable.

In the absence of, or even with, a universal public service obligation the only way to ensure 100 per cent coverage of the eligible population (as it is currently defined) through the open market would be to allow providers to charge significantly higher rates than we think acceptable, leading to poorer outcomes for savers. Among those able to access pension provision, the lowest earners are likely to attract the highest charges, whilst those with higher salaries will be able to access pensions with lower costs, since they are more profitable to the market. Thus the lowest earners at whom the pension reforms are targeted would be disproportionately disadvantaged under a free market model.

Impacts on employers

In addition to the impacts on individuals, the free market option would potentially present an increased burden on employers, who would find it harder to access pensions, and would need to put more time and effort into securing provision. The smallest employers would find it hardest to secure a scheme, have the least experience and confidence with pensions, and are concerned about the responsibility of taking such decisions on behalf of their employees.

4.6.3 Subsidise providers

An alternative to allowing unlimited charges would be to cap charging, but subsidise providers to offset the costs of the least profitable segments of the market. This could be done through a general subsidy, for example tax relief, or a subsidy just to compensate those companies serving unprofitable employers; the latter option would be the fairest, most cost-effective way to ensure that the government subsidy was used appropriately.

Any subsidy would need to take into account the economies of scale enjoyed by providers, along with the degree to which they were serving unprofitable segments of the market. There would need to be continuous monitoring to ensure that subsidies continued to be focused in the right way. Offering subsidy to some providers but not others would raise state aid concerns, which would need to be considered.

This option would entail ongoing costs for government, both in terms of the subsidy itself and in setting up and running the necessary systems to monitor provider activity in the market and distribute the subsidy accordingly. However, this would be at least partially offset by savings on the cost of building the new infrastructure for NEST. Overall, subsidising the pensions industry as it stands or even with the widespread introduction of master-trusts would not involve the same economies of scale as a single scheme with a public service obligation. Therefore, in the long term, the ongoing subsidies are likely to exceed the costs associated with setting up NEST.

4.6.4 Limited number of default providers sharing the public service obligation

This option would involve applying the public service obligation to a small number of pension providers who would join a default 'carousel'. Any employer who was unable – or unwilling – to find a pension provider on the open market would be randomly allocated a provider from the carousel, potentially via a simple gateway on The Pension Regulator's website.

Coverage and impacts for consumers

The application of a public service obligation would ensure that every company and individual would be able to access pension provision. Furthermore, the provider carousel would, in theory, capture the employers we would otherwise expect to use NEST, supplying sufficient volumes and thus economies of scale to deliver low charge levels.

However, one of the key perceived benefits of NEST is that it is simple, portable, and designed specifically to meet the employer duties; employers may be positively attracted to the scheme for these reasons, including those whom it may be profitable for the open market to serve. For example, some very large employers with existing provision may seek to use NEST for certain segments of their workforce, running this in parallel with their own schemes. In the absence of the NEST branding, it may be the case that these more profitable employers disperse across the entire market, as there is little to attract them to the carousel. In this case, the provider carousel would be left with just the least profitable companies, and may need to increase their charge levels to compensate, leading to poorer outcomes for members. If the provider carousel had higher charge levels than schemes on the open market, employers may be deterred from using it for fear of making choices that lead to poorer member outcomes. This would then exacerbate the problem of only the very least profitable business going to the carousel.

Impacts on the pensions industry

The competition impacts of this option depend on the extent to which providers on the carousel are able to use the cost reduction of government-provided administration, or the revenue from a compensatory subsidy, in their general business. It would be difficult to identify whether a carousel provider was using these features exclusively for the business they received through the carousel, or used the cost reduction to more keenly price or reduce costs in open market areas.

Programme costs and delivery

It may be difficult to attract providers to compete to be part of the carousel, due to the unprofitable nature of this business, although we would envisage that any provider on the carousel would also operate in the open market and obtain profitable market share that way. However, we might need to consider offering incentives to providers to belong to the carousel. For example, Government could provide an administrative front end to the carousel to manage the collection of contributions, reducing costs for those providers; alternatively we might consider a direct subsidy, entailing an ongoing cost to Government.

Legislatively, the establishment of a carousel would be complex to design and implement, and further analysis would be needed to establish how this might be achieved. The costs to government of this option would comprise the costs of any necessary subsidies to providers on the carousel. If Government were to supply an administrative front end there would also be substantial cost implications in terms of the set up of new IT and administrative systems, and the ongoing running costs.

It is also difficult to envisage how such an approach could be developed and implemented in a way that supported a stable introduction for the reforms in October 2012. We would anticipate that the start date for the reforms would inevitably be delayed.

4.6.5 Free market response: systematic establishment of Master-trusts

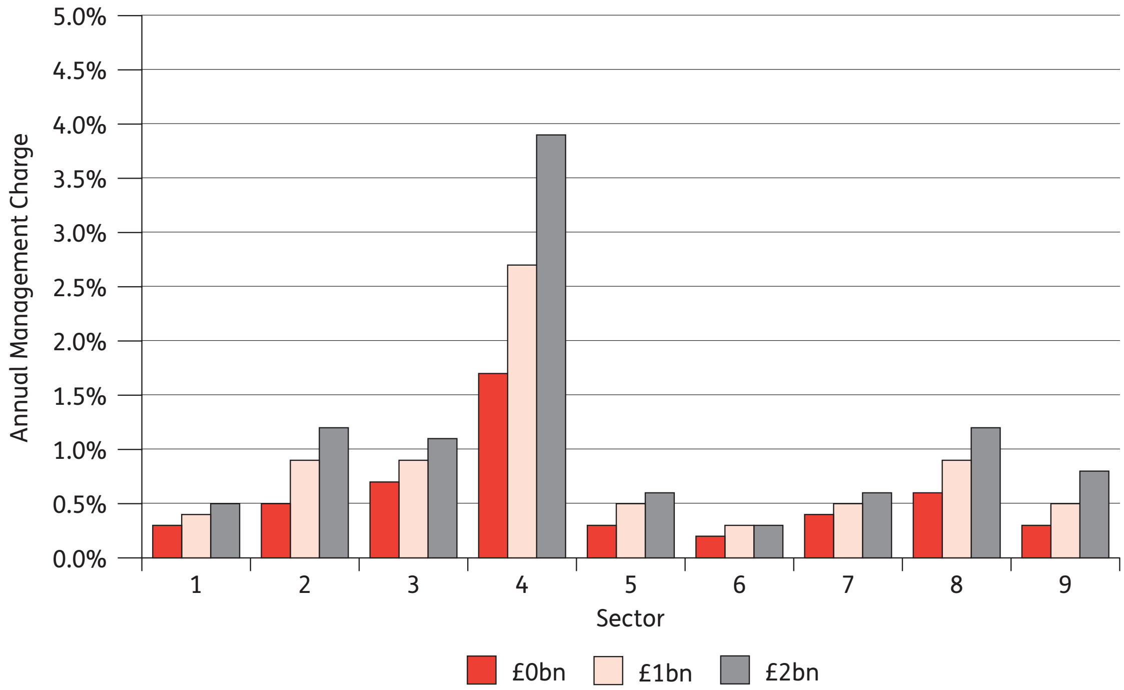
Master-trusts are trust-based occupational schemes which seek to generate economies of scale by operating on a multi-employer basis, removing employer-specific trustee duties, whilst retaining a single trustee structure. A product provider will have set up the trust and installed a group of trustees to run it. The provider will also supply administration and investment services to the trustees. These schemes tend to be set up from scratch explicitly with the purpose of serving multiple employers, who may be entirely unrelated. A super-trust is a similar concept, but involves grouping existing employer-sponsored occupational pension schemes. These employers will be grouped together based on region, location, industrial sector or on a national basis. The schemes will then have centralised administration functions and one board of professional trustees.

Master-trusts are more complex than normal pension schemes to administer and are not currently widespread in the UK; research by Deloitte for DWP in 2008 identified only three master-trusts at that time, run by Standard Life, Prudential and Legal & General. Whilst these are examples of schemes run by pension providers, master-trusts could be also set up and run by employee benefit consultants (EBCs).

Coverage and impacts on individuals

The key benefit of these arrangements is that they facilitate greater economies of scale and allow the schemes to offset higher revenues from more profitable employers against the costs of less profitable members. Capita Hartshead research figures suggest that schemes with more than 50,000 members cost around £15-£20 per member whilst schemes with fewer than 1,000 members cost £150 per member. More detailed analysis demonstrates the potential scale of the effects of pooling. Chart 4.4 illustrates the charge levels needed to generate ‘break even’ points (zero aggregate net present value) when pooling employers by industry. Chart C3.3.1 in Annex C shows the charge levels needed by employer size. In particular, across all sectors other than hospitality, pooling would allow schemes to operate at charge levels substantially lower than 1 per cent AMC.

Chart 4.4: Impacts of pooling employers by sector: AMC levels needed to generate £0 NPV, £1bn profit or £2bn profit



Sector:

1	C: Mining and quarrying; D: Manufacturing; E: Electricity, gas and water supply
2	F: Construction
3	G: Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods
4	H: Hotels and r estaurants
5	I: Transport, storage and communication
6	J: Financial intermediation
7	K: Real estate, renting and business activities
8	M: Education; N: Health and social work
9	A: Agriculture, hunting and forestry; B: Fishing; O: Other community, soc ial and personal service activities

Source: Department for Work and Pensions modelling.

In the long term, master-trusts can potentially provide access to pensions at lower charge levels than single schemes under a free market option. However, setting up master-trusts involves significant development and administration costs. Existing pension providers would need to set up and run the master-trusts in parallel with their legacy business, requiring two separate administrative platforms. Deloitte's research estimated the cost to a provider of adapting their existing systems as between £2-20million, and the cost for setting up an entirely new system of around £100million (an EBC or trade body choosing to set up a master trust would likely incur similar costs). These costs would need to be recouped via member charges, and so it is not clear that this would be a more cost-effective option for savers in the shorter term.

We have some anecdotal evidence that employers are looking to move to master-trust arrangements in response to the reforms, in order to take advantage of short service refund rules in occupational pension schemes.

Impacts on employers

Master-trusts offer an advantage to employers when compared with traditional occupational schemes, since the employer does not bear the cost and administrative burden of setting up the scheme. However, some employers may still find it difficult to access provision, with the associated costs and burdens of trying to access pensions. It is conceivable that some employers may still be unable to purchase a pension scheme and become non-compliant through no fault of their own. It would be more difficult for The Pensions Regulator to enforce compliance in this context.

Impacts on the pensions industry

On the face of it, this option would appear to entail very little competitive distortion, since it is an entirely market-based solution. However, pension providers have expressed significant concerns that the widespread establishment of master-trusts could destabilise the market. They worry that employers might be strongly encouraged to reconsider their existing pension provision by intermediaries (who stand to earn fees or "consultancy charges" on each re-sale of a pension scheme[73]). The consequent market churn could be damaging to pension providers, who rely on the long term "embedded value" of pension products, based on expectation of future profits.

To some degree, the success of a super-trusts model is also dependent on the market remaining fairly static. Pooling allows providers to offset the costs of less profitable business with the revenues from more profitable business only where the provider is able to retain the more profitable end. New providers entering this market would look to attract the most profitable business away from existing master-trusts, upsetting the fine balance enabling low charges across the market.

Programme costs and delivery

It is difficult to see how, in the absence of other levers, Government could persuade pension providers (or other organisations) to bear the costs, and potential risks, of setting up master-trusts solely to achieve sufficient economies of scale to allow them to take on unprofitable business. It may be necessary to provide incentives to encourage this approach, for example through a subsidy. This is likely to be lower than the subsidies that might be required under a general free market option, due to the greater economies of scale offered by master-trusts. It is, again, difficult to envisage how this approach could be developed and implemented in a way that supported a stable introduction for the reforms in October 2012.

As with the general free market option, this option could present higher compliance costs if The Pensions Regulator is operating in a more challenging compliance landscape, plus the costs of any necessary incentives.

73 Under the Retail Distribution Review changes, commission will be replaced by "consultancy charging."

4.6.6 The Danish Model: a national collective defined contribution scheme

One model that has been cited by some stakeholders in the context of UK pension reform is Denmark's ATP scheme, which has very low charge levels. ATP was established as a statutory pension fund in 1964, and amended in 2008. It is a mandatory scheme with both employer and employee contributions, providing a hybrid benefit with some guarantees and additional benefits on top depending upon scheme performance. ATP covers almost the entire Danish population representing 4.6 million members and 160,000 employers.

As a risk-sharing collective defined contribution scheme, ATP does not have charges that are strictly comparable with annual management charges in group personal pension schemes. Nevertheless, ATP scheme costs are very low. There appear to be four key factors driving these costs down.

- State funding: set up costs were met by the Danish State and there are no legacy financing costs; all costs are just from running the scheme.
- Compulsion: the scheme is mandatory and therefore incurs negligible marketing costs. It also does not have to process opt-outs or opt-ins, further reducing costs.
- Economies of scale and pooling: not only is the scheme very large, but it captures the entire market, allowing ATP to offset costly members against more profitable ones, with no risk that other providers may cream off the most profitable business.
- Cost reduction by eliminating administration: the scheme piggy-backs on existing government tax administration to obtain information about members and calculate contributions, avoiding duplication and increasing accuracy, especially in processing small employers.

We have been asked by some stakeholders to consider whether government could replace the NEST proposition with a collective defined contribution scheme, and whether we could achieve even lower charges this way. Looking into this question, we have identified two significant barriers, which we will address in turn.

First, the Danish ATP scheme is run by a single provider, covering almost the entire working population, and forms a core part of the Danish state pension system. The effects of pooling and economies of scale help to drive down charges, and are possible because ATP effectively has a monopoly; contributions to the scheme are compulsory. Further, the scheme does not have to cover legacy financing costs, since these were met by the state.

The only way to exactly replicate this in the UK would be to have a state-sanctioned provider take over the existing workplace pensions market as well as taking on a public service obligation for all new members to form a single, state-subsidised scheme. We contend that introducing this kind of system is not possible in an economy with such a highly developed financial sector as the UK. The alternative to a state-sanctioned monopoly would be to have a number of collective schemes, i.e. master-trusts or supertrusts, as discussed in Section 4.6.5.

Second, two significant contributors to Denmark's low costs are absent in the UK. Not only is their scheme compulsory for all employees, but the costs of administering small employers are drastically reduced by the use of the tax system for data flows and calculations. An equivalent use of HMRC data systems (obviating the need for new administrative systems) would enable other schemes, including NEST, to have lower charge levels.

We understand that this would require a significant overhaul of HMRC's systems, since it does not currently have the capacity to administer pension savings. In addition, PAYE records are only reconciled annually, when tax and National Insurance Contributions are checked and finalised to ensure they are correct, based on the individual's earnings that year. This means that there would be a significant delay between an individual making a contribution and that money being invested, resulting in a loss of investment growth. We note that HMRC have recently consulted on improvements to PAYE systems that could address some or all of these difficulties. However, our understanding is that such changes are unlikely to be available to support the administration of workplace pensions within any short timeframe and, therefore, would involve an unacceptable delay to the introduction of automatic enrolment.

It is also important to remember that Denmark's ATP scheme is a very large, mature pension scheme, established over forty years ago. In 2010, funds under management were in excess of $100bn. As such, it is not directly comparable with the NEST proposition, as a brand new scheme.

4.6.7 Development of alternative infrastructure

A number of stakeholders have suggested that there may be ways of developing an alternative infrastructure to support the reforms that would allow the pensions industry to offer low cost workplace pension products to a much wider range of employers. The ways in which this infrastructure was envisaged varied in the detail, but ideas centred one or more of three themes:

- Establishing a common and automated process for collecting information and contributions from employers.
- Maximising the capacity and capability already established within the pension industry.
- Utilising other existing infrastructure, for example the information collected by HMRC for tax purposes or the process for assessing and collection in the PAYE system.

Some stakeholders pointed to potential developments to the PAYE system as a possible future infrastructure that could support both the collection of income tax and contributions to a workplace pension.

Having considered the various proposals put forward, we concluded that:

- While there were conceptual opportunities to develop cross-industry infrastructure that could reduce costs and involve a smaller state initiated intervention to the pensions market, these would involve a fundamental change to the programme and delay implementation of automatic enrolment by perhaps up to three years.

- The proposals have not benefited from the extensive work that has already been invested in proving the NEST concept. Several alternative proposals might appear feasible on the surface, but none can command the high degree of credibility that NEST has on its delivery.

The majority of stakeholders are strongly in favour of retaining an October 2012 start to the implementation of the reforms. This is seen as important, both to ensure an intervention is made as quickly as possible to address the consequences of demographic changes resulting from the ageing of the "baby-boom" generations, and because the current broad approach is backed by a strong consensus and has a strong delivery momentum.

Our conclusion is that exploring alternative infrastructure would be likely to delay implementation of the reforms by at least three years without any guarantee that this would lead to a more optimal outcome.

4.6.8 The current policy: NEST

NEST is intended to meet the supply gap by serving all those companies and individuals who are unable to find pension provision elsewhere. NEST will be a trust-based occupational pension scheme, managed by a corporate trustee, and will operate broadly in the same way as any other defined contribution occupational scheme. The scheme will have a public service obligation to accept any employer (and any qualifying employee) that wishes to use it.

NEST has been designed to meet the needs of a particular target group, including smaller employers and individuals who tend to have lower earnings and lower financial literacy, and are most vulnerable to loss. For these reasons, NEST incorporates a number of protective features, including low charge levels and a default investment strategy which is likely to be cautious to match the risk appetite of the target group. There will be an annual contributions limit and a restriction on the transfer of benefits into and out of NEST, in order to focus the scheme on its target market.

NEST is able to achieve low charges for groups that the existing market finds it difficult to serve through a simple product proposition, supported by a technology driven delivery model, in conjunction with improved persistency of saving amongst its members and economies of scale.

The costs of establishing and operating NEST will ultimately be met from member charges. However, until revenue streams are established, the set up costs and early years running costs of NEST will be funded by a Government loan. This results in a peak financial commitment to NEST from Government of between £0.5bn and £1bn, which will be repaid over a period of around two decades.

Coverage and impacts on individuals

The provision of a new scheme with a public service obligation will ensure 100 per cent pension provision across the market. More than this, the Pensions Commission's key argument for the need for a National Pension Savings Scheme (now NEST) was to supply universal access to pension saving at a low cost to the member. They argued that low costs would be achievable through high membership, and thus economies of scale, along with very high persistency. They anticipated that the National Pension Savings Scheme would have sufficient coverage that most workers would end up saving in the National Pension Savings Scheme for a significant chunk of their working lives, typically through different employers at different times, reducing the costs associated with member churn.

DWP estimates put the number of people who will be automatically enrolled between 10-11million; the Pensions Commission's expectation was that most of these would end up in the National Pension Savings Scheme (now NEST). There is now a greater emphasis and expectation of employer choice of scheme and the anticipated take-up of NEST now is around 1 million employers, resulting in between 3-6 million members. These volumes are still very high and allow the scheme to make savings through economies of scale, in spreading fixed costs across a large number of members. In addition, NEST will be limited in the extent to which it can compete with the existing providers thus restraining marketing and advertising costs.

The question of persistency of savings is more complex. While the majority of employers are expected to use NEST, this will affect less than half of all those automatically enrolled, so the Pensions Commission's expectation that most employees would move from job to job and remain within NEST may not hold true. We expect that most micro and small employers will use NEST, but in order for the argument to hold, employees within these firms would have to work within the same sized employers for the majority of their career, which is not the case in practice. The analysis in Chapter 5 (Table 5.4) shows that the vast majority of employees working for smaller employers move into firms with more employees and the overall proportion of employees who continue to work in the same size firm increases with size. Employees who work for employers with only one employee were the least likely to stay working in the same size firm, 32 per cent, compared to 44 per cent of employees working for employers with four or fewer employees and 55 per cent of employees working for an employer with 19 or fewer employees[74]. Nevertheless, the persistency gains will still be greater for NEST than under scenarios where NEST does not exist, since employees are likely to return to NEST more often than they would any other single scheme.

The combination charge level chosen for NEST is broadly equivalent to an AMC of 0.5 per cent, comparable with charge levels currently available to higher earners and those in large workplace schemes. Low to median earners, the target market, are very unlikely to be able to access pension provision at these rates under a free market option.

74 The 20 per cent sample cut in 2007 and 2008 will have an adverse affect on results and have been excluded. The results are based on un-weighted data, and restricted to the main job. The results marginally under-estimate the number of employees staying in smaller employers from one year to the next because the sampling frame slightly under-represented smaller firms, and because employer growth (workforce increasing from 4 to 5 employees) will be classified as a move between employers. Missing data due to an employee either leaving employment, or employer non-response will result in a marginally under-estimate the number of moves between employers over the 10 year period. The net effect is unknown. For this reason, great care should be taken when interpreting the results.

Impacts on employers

The existence of a low-cost scheme with a universal public service obligation reduces the burden on small employers who might otherwise expend considerable time and effort in identifying a scheme willing to serve them at an acceptable cost. Small employers have expressed particular concerns about how they will choose a pension scheme to meet their new statutory duties. Provided that NEST is clearly signposted to small employers as having a public service obligation and having been designed with the needs of small employers in mind, we believe that these very real concerns can be mollified.

Impacts on the pensions industry

NEST has a contribution cap and a restriction on transfers into and out of the scheme in order to focus it on the supply gap and so that it does not replace the existing pensions market. Nevertheless, it is likely that NEST will attract segments of the market that could be served by the existing pensions industry, even at relatively low charge levels. The charge levels in NEST may also drive down charges across the market, in the same way as the stakeholder charge cap has done. Providers have expressed concern that this imperative to compete on charge levels will further limit their market penetration.

Programme costs and delivery

NEST is on course to support the delivery of the reforms from October 2012. Upfront funding via a loan results in a peak financial commitment to NEST from Government of between £0.5bn and £1bn, which will be repaid over a period of around two decades.

4.6.9 Restrict NEST to certain customers

Whilst there was support for NEST in stakeholder feedback, criticism from the pension industry in relation to NEST tends to focus on Government financial support for a scheme that will compete for segments of the market that could be served by the existing industry, rather than solely plugging the "supply gap". One option therefore might be to limit NEST's membership by preventing the scheme from accepting certain types of members.

The most straightforward way to do this legislatively would be to modify the scheme order to restrict NEST with regard to the size of employer it is able to accept. So, for example, restricting NEST to only taking on employers with fewer than 20 workers.

This option would preserve the current market outcomes, since pension providers would be free to compete for profitable business on charges and products as they do now, without facing competition from a large, government-financed scheme. At the same time, individuals would still have access to a low-charge scheme that offers protection to the most vulnerable savers.

Coverage and impacts on individuals

Defining the threshold for this restriction would be challenging since employer size is only a rough proxy for profitability and there is a risk that a supply gap could persist. Providers reported in DWP research that they look at a wide range of factors to estimate profitability, including member salary and contribution rates, workforce age profile, employee churn, employer commitment to pensions and industry sector[75].

75 Wood, A, Leston, J and Robertson, M, 2009, "Pensions industry responses to the workplace pensions reforms", Department for Work and Pensions Research Report No 592.

We assume that in the absence of NEST the open market would charge up to the current stakeholder cap. However, with NEST in existence and offering relatively low charges (albeit it may not be able to deliver charges as low as a 0.5 per cent AMC equivalent given a restricted membership), we would expect this to influence the rest of the market in driving charge levels down. It is conceivable therefore that there could be some employers who are too large to go to a restricted version of NEST, but who are still deemed to be unprofitable by the pensions industry.

Further, the current assumption is that NEST will be used by smaller firms, but also by large firms who wish to use it for the lower-paid or short-term segments of their workforce. Restricting NEST's ability to accept business will inevitably limit employers' options and flexibility in terms of their pension provision. This also potentially results in poorer outcomes for lower-paid workers in large organisations, who would not be accepted by NEST and thus may be subject to higher charges on the open market.

Impacts on employers

Restricting NEST to certain categories of employers or individuals presents a confusing message. There is a risk that this could damage the contingent consent and thus compliance levels, simply because employers are unsure of their duties and options. Further, there is the risk that some employers could find it very difficult to access pension provision and become non-compliant unintentionally.

Programme costs and delivery

Amending NEST in this way would require changes in secondary legislation, which could be completed before the planned implementation in October 2012. However, there would be wider implications for the scheme administration arrangements, which may result in delays to implementation. Restricting NEST's membership to unprofitable business is likely to affect the scheme's ability to pay back the Government loan, and could even mean that the scheme would need ongoing subsidy.

4.7 Conclusion

Starting from a proposition of wanting to provide relatively low-cost pension provision for individuals without very significant reductions in the scope of coverage of automatic enrolment, our profitability analysis supports the Pensions Commission's argument that there is a supply gap in the existing pensions market. This gap persists despite the introduction of automatic enrolment; in fact, automatic enrolment counter-intuitively decreases overall profitability in the market, due to the inclusion of new savers with low salaries, low contribution levels and relatively high job churn.

We conclude that it would be wrong to ask the existing pensions industry to cover the whole of the automatic enrolment population, either through higher charges or through some form of subsidised charges. A significant risk in asking the pensions industry to cover a new and, at current charge levels, unprofitable client group would be substantively higher charges. These would impact both on new savers and potentially lead to higher costs in the wider market place. This would undermine the hard won gains in terms of value for money that we have seen over the last ten years.

By contrast, we believe that the introduction of NEST will both offer good value to its target audience and provide a high benchmark for the rest of the pensions industry. We hope that, in many areas, existing pension providers will raise their game to meet this competition, providing further improvements in value for money for those being enrolled into pension saving.

The Pensions Commission set out the basic choice the nation faces: save more or work longer or pay higher taxes. They saw the "save more" option as critical to ensure the large "baby boomer" generation save now for their own retirement, rather than asking the smaller generations that follow to pay for them through taxation. Probably inevitably, the programme has already taken longer to implement than the Pensions Commission envisaged, but to delay it further, maybe by up to another three years, while alternative models are investigated and built, would be to undermine seriously the basic concept of "save more".

Mindful of the need to make progress, we reject alternative proposals that would add a number of years to the timetable and which do not have the strong certainty of delivery that NEST has built up to date.

We conclude that NEST is a necessary part of ensuring universal access to a pension scheme at acceptable cost to the member. This view is also held by the majority of stakeholders who responded to our consultation during the review. Consumer and employer groups see NEST as a necessary and integral part of the reforms, and even industry representatives do not feel that that they can – or would wish to – provide a workable alternative to NEST.

We believe that NEST will be a force for good, setting high standards for the UK's pension provision, and working with the pension industry to improve customer outcomes.

Target group 5

Summary

In this chapter, we look at the proposed scope for automatic enrolment and consider a number of changes, analysing the impact on individuals and employers. We do not make specific recommendations at this stage, as the overall impacts and benefits can only be assessed when all the different areas of analysis in this report are brought together, including how changes in scope might impact on the regulatory burden, on profitability in the pensions market and on the need for NEST. Chapter 8 brings all these factors together.

The main areas for change that we have considered are:

- **increasing the earnings threshold**
- **introducing a waiting period**
- **excluding some employers**
- **excluding older workers**

Table 5.7 provides a summary of the impact on individuals, employers and industry for all options.

Consultation with stakeholders brought mixed views on the earnings levels at which individuals should be automatically enrolled. Concern was raised about including low earners for whom it may not pay to save. Some felt a small increase in the level was justified and that alignment with existing National Insurance or tax thresholds would ease administration burdens for employers. Analysis shows us that lower earners tend to achieve high replacement rates from the State alone. However, the dynamics of family and working life may mean that many lower earners may benefit from saving at a lower wage. Low earners are predominately women and therefore raising the threshold significantly is likely to have a particular

effect on women. Raising the threshold will reduce costs for employers and aligning thresholds with existing tax and national insurance is likely to ease the administration burden for employers.

The strongest call for waiting periods came from employers wanting to reduce the cost of enrolling short term and temporary workers. Consumer groups felt this would reduce overall saving and penalise those who change jobs frequently. Overall, the introduction of a waiting period has a largely negative impact on individuals, reducing overall saving for an average of 5.5 years with a 6 month waiting period. Employers save on both administration costs and contribution costs by not having to automatically enrol individuals who leave the company after a relatively short period of time.

We saw in Chapter 3 that the smallest employers would face high costs from automatic enrolment. However, whilst stakeholders recognised that the reforms would be most difficult for the very smallest employers, most felt that all employers should be covered by the reforms irrespective of size. Consumer and employee representative groups felt exempting small employers would be unfair to those individuals who worked for them. Analysis suggests that many individuals spend a relatively small part of their lives working for smaller employers before going on to work for larger employers. They would, therefore, be automatically enrolled at some future point in their working lives, but would lose out for the period of time that they are working for the smaller employer.

There were some concerns from stakeholders that it might not pay to save for those individuals who are close to retirement when the reforms are introduced, though there was limited appetite for excluding older workers amongst both employer and consumer groups. Analysis shows that many older workers already have past savings and would benefit from topping up these savings. Even those individuals who do not have past savings and who would only have time to build up a small pot could trivially commute their savings. They would, therefore, benefit from taking a lump sum with no negative impact on benefit entitlement. In the short term only, employers would see minimal contribution and administrative savings.

5.1 Introduction

We were asked to consider whether the proposed scope for automatic enrolment strikes an appropriate balance between the costs and benefits to both individuals and employers. The three main groups of options covered in this chapter that change this balance cover:

- Increasing the earnings threshold.
- Introducing a waiting period.
- Excluding some employers.
- Excluding early cohorts of older workers.

We have focussed primarily on the effects these options have on individuals and employers, but we have also considered the knock-on effects on industry, the Pensions Regulator, NEST and the Exchequer. Throughout the chapter, the discussion focuses on the effect of each change relative to the current approach and target group.

This chapter considers the various options separately. However, to some extent they affect the same individuals and employers. For example, micro employers are more likely to employ low earners and have a higher staff turnover.

In examining each option, the chapter looks at the case for change, stakeholder views expressed to us during the review consultation, options for change, and the key impacts of those options. The chapter starts by looking at options for changing the earnings threshold for automatic enrolment (Section 5.2); then considers waiting periods before automatic enrolment (Section 5.3); then looks at excluding smaller employers from the employer duties set out in the Pensions Act 2008 (Section 5.4); and finally looks at options for changing the age thresholds for automatic enrolment (Section 5.5). The comparative impacts of the changes are summarised in a table in the conclusions (Section 5.6).

5.2 The Earnings Threshold

5.2.1 Why consider change?

The Pensions Commission originally proposed that individuals would be automatically enrolled when they earn enough to pay National Insurance contributions. At this level of earnings an individual would accrue a Basic State Pension, which would give them a basic income in retirement on which to build through additional saving. They also recommended that pension contributions were calculated on earnings between the National Insurance contributions primary threshold and the National Insurance upper earnings limit. Therefore, in 2006/7 terms, individuals would be automatically enrolled when they earned at least £5,035, the then National Insurance contributions primary threshold, with contributions being calculated on all gross qualifying earnings between £5,035 and £33,540. The Pensions Act 2008 requires these thresholds to be up-rated in line with earnings, so consequent changes have caused them to become unaligned with the National Insurance thresholds, which have been up-rated in different ways.

The primary reason to consider changes to the earnings threshold for automatic enrolment is that there may be individuals who are consistently lower earners and find that the State, through pensions and benefits, provides them with a sufficiently high replacement rate without additional saving. For these individuals it may not be beneficial to redirect income during working life into pension saving. As discussed in Chapter 2, the Pensions Commission used the concept of the ‘replacement rate’ to measure the proportion of working-age income that is ‘replaced’ by income in retirement.

Another reason for change would be to re-align thresholds with other current earnings triggers, such as the National Insurance and tax thresholds. This would both simplify administration for employers and ensure that only those that earn enough to accrue a Basic State Pension are automatically enrolled into private pension saving.

5.2.2 Stakeholder views

In our consultation with stakeholders, there were mixed views on the earnings level at which individuals should be automatically enrolled. Industry, employer and consumer groups all expressed concern that the current policy included some low earners for whom it might not be worthwhile saving. Many thought there was a case for increasing the threshold at which an individual would be automatically enrolled, though there were different views on what level it should be. Stakeholders were clear, however, that while it may be appropriate to raise the threshold for automatic enrolment, the levels of earnings from which contributions are calculated once an individual is enrolled should not be increased.

Consumer and employee representatives generally supported as broad a scope for automatic enrolment as possible and wanted to ensure that key groups (especially women) were included. However, they had some concerns about the affordability of pension saving for lower earners, and that the interaction with means-tested benefits may reduce returns for some groups. There were different views on the policy implications of this dilemma. Some felt it justified a small increase in the earnings threshold, whilst others believed there was no case for change because individuals are already able to opt out of pension saving.

Employers supported a slight increase in the earnings threshold. This was predominantly driven by concerns about what they perceived as an unnecessary administrative burden, which they felt could be removed if the pension thresholds matched thresholds in the National Insurance system. Chapters 3 and 6 discuss employer concerns in relation to administrative burdens and de-regulatory measures to ease those burdens.

The strongest support for increasing the earnings threshold came from industry representatives, with many suggesting that £10,000 was an appropriate threshold.

Others suggested that the earnings threshold(s) could be linked to National Insurance thresholds, tax thresholds or National Minimum Wage levels.

5.2.3 Options

We start with the premise that we should take the opportunity to re-align the earnings threshold with existing earnings triggers for tax and National Insurance, provided there is a trigger within a sensible reach of the optimum triggers for automatic enrolment.

However, the critical issue for us is that the right balance of risk is achieved in setting the earnings threshold: a low earnings threshold has a greater risk of automatically enrolling an individual into pension savings who will not benefit from saving (relying on them to opt-out), while a higher threshold risks not automatically enrolling an individual who should be saving (relying on them to opt in).

In exploring the impact of changing thresholds and assessing the balance of risks involved, we have looked at four options for the threshold at which an individual becomes eligible for automatic enrolment:

- The National Insurance primary threshold – a small change, realigning the automatic enrolment threshold with the National Insurance primary thresholds (£5,715 in 2010/11).

- The income tax threshold – this raises the threshold slightly, aligning it with the threshold for income tax, removing the lowest earners from the scope of automatic enrolment. The Government have announced a real increase in this threshold to £7,475 in 2011/12 (£7,336 in 2010/11 terms).
- The Government aspiration for future income tax thresholds – removing a more significant proportion of lower earners from automatic enrolment (£10,000 in 2010/11).
- Setting a level above full-time work at the National Minimum Wage – to test the impact of removing a significant proportion of lower earners from automatic enrolment (£14,000 in 2010/11 prices).

For all options, we concluded:

- That the point at which contributions are deducted should be aligned with the National Insurance primary threshold. This ensures that, even with a higher entry threshold, individuals who are automatically enrolled have their pension contributions calculated on a significant portion of their income.
- Minimum contributions are calculated on earnings between £5,715 and £38,185 (the original £33,540 uprated to 2010/11 earnings levels). We do not recommend aligning the top end of the band with the National Insurance upper earnings limit (£43,875). This has moved significantly away from its level at the time of the original proposals and re-alignment may result in a significant increase in employer contributions for some employers with particular earnings profiles. We did not think is was an appropriate time to add further burdens on employers, but recognise that realignment may be appropriate in the future. We suggest that Government consider this as part of their review of the reforms in 2017.

5.2.4 Key findings

Impact on individuals

Increasing the earnings threshold will reduce the number of individuals who are automatically enrolled (see table 5.2), so it is important that we understand the characteristics of the groups affected and the impact that no longer being automatically enrolled at this point in their working lives would have on their income in retirement.

Increasing earnings thresholds disproportionately affects women. For example, setting the threshold at £7,336 would see 78 per cent of the group no longer captured being women, (or 76 per cent at £10,000 and 68 per cent at £14,000). This disproportionate impact on women is something we would wish to avoid if we believed that these people would benefit from saving.

There are a number of reasons to conclude that not automatically enrolling some low earners is the right thing to do:

- Persistent low earners get a high replacement rate from the State. As we saw in Chapter 2, individuals who are low earners throughout their lifetime receive relatively high income in retirement without private pension saving. For example, an individual earning £10,000 per year from the age of 22 would see a replacement rate of around 97 per cent from the State alone. For these individuals, it is questionable whether it is beneficial to redirect money into private saving.
- Individuals can opt in. Where the individual feels that they would benefit, they can opt in to pension saving if they wish. This means that employers would need to enrol voluntary savers into a pension scheme and pay employer contributions for those earning more than £5,715.
- Where earnings increase over time, the individual is brought in to pension saving when they have more money. The analysis in Chapter 2 showed how most individuals on low earnings subsequently go on to earn more. We can use this information to look at the impact of a higher earnings threshold on individuals whose earnings increase over time. Table 5.1 does this by increasing the age at which an individual is assumed to start making contributions, depending on the earnings threshold. It shows that, with higher earnings thresholds, the impact on weekly income in retirement is small, though there is also an impact on the lump sum the individual can take at retirement.

Table 5.1: Impact on low earner

Earnings threshold	**£5,715**	**£10,000**	**£14,000**
Contribution starting age	**25**	**29**	**36**
Private pension weekly income at retirement £	19.40	19.13	17.59
Lump sum at retirement *£000*	9.3	9.1	8.2
Net replacement rate at retirement *percentage*	62.3	62.2	61.8

Note: An individual with an earnings trajectory from £8,000 at age 25 to £20,000 by age 45.
Source: Department for Work and Pensions modelling.

In addition to the impact of increasing the earnings threshold, there is an impact on individuals from separating the threshold at which automatic enrolment occurs (£7,336, £10,000 or £14,000) and the band on which contributions are calculated and deducted (£5,715 to £38,185). Splitting the threshold and lower band in this way means that when individuals are enrolled, they start saving amounts of money that could more significantly increase their income in retirement. However, it also creates a potential cliff edge, where small increases in earnings could tip them over into making significant pension contributions. So they could see their take home pay fall. However, our analysis, in Annex C.4.2, suggests that this impact should be minimal.

Impact on employers

Increasing the threshold at which automatic enrolment occurs and separating the earnings threshold from the band on which contributions are deducted will have slightly different impacts on employers.

Increasing the automatic enrolment threshold means a reduction in the number of individuals automatically enrolled, leading to both administrative and contribution cost savings. Micro employers tend to benefit most from reduced administrative and contribution costs as they are more likely to employ low earners – around two thirds of individuals who work for micro employers earn less than £15,000, compared with around a third of individuals who work for employers with at least twenty workers (see Chapter 3).

Separating the earnings threshold from the lower earnings limit reduces the number of individuals who repeatedly start and then stop making contributions because of fluctuating earnings. It therefore reduces the administrative burden associated with such individuals. And where administration costs are incurred, they will be more proportionate because they will be incurred in making more significant amounts of contributions.

The administrative and contribution cost savings with each alternative earnings threshold is presented in Table 5.2.

Table 5.2: Impact on individuals and employers of different qualifying earnings

Qualifying earnings threshold	Individuals			Employer costs	
	Total coverage	% female	Other characteristics	Contribution costs	Administration costs
Current target group	10 - 11m	40%	12% BME 12% disabled	**£3,240m**	**£444m in Year 1** **£127m ongoing**
NICs Primary Threshold			Minimal change		
£7,336	-0.6m	78% (of the 0.6m) 38% in revised overall target group	No particular impacts by ethnicity, disability or age group. No disadvantage as individuals retain the right to opt in	-£20m	-£4m in Year 1 -£3m ongoing
£10,000	-1.4m	76% (of the 1.4m) 36% in revised overall target group		-£50m	-£8m in Year 1 -£6m ongoing
£14,000	-2.9m	68% (of the 2.9 m) 32% in revised overall target group		-£250m	-£22m in Year 1 -£12m ongoing

Source: Department for Work and Pensions modelling.
Annual Survey of Hours and Earnings, Great Britain 2009, Office for National Statistics.
Family Resources Survey, United Kingdom 2003-04, 2004-05, 2005-06, Department for Work and Pensions.

Impact on the pensions industry and the Exchequer
Separating the earnings threshold and the band on which contributions are paid will help reduce the number of small pots of pension savings which are disproportionately costly for industry to administer. The smallest contribution going into a pension pot would be £130 per year for an individual with earnings of £7,336 (£343 at £10,000 and £663 at £14,000). However, the size of the pension pot accumulated will also depend on the persistency of the individual's saving. An individual contributing a small amount over a long period of time could still build up an adequate size pot.

Savings for the Exchequer are relatively low with this option because overall savings levels do not change significantly. This is because those who are enrolled still make contributions from the lower earnings band. And those who are no longer enrolled would have been making small amounts of contributions in any case.

5.3 Introducing waiting periods prior to automatic enrolment

5.3.1 Why consider change?
Current policy is that all employees should be automatically enrolled on the first day of their employment or when they become eligible. Many employers have expressed concern that this could lead to costs associated with enrolling large numbers of employees working for short periods. The administrative burden may also be eased by allowing employers more time to complete all the processes involved in automatic enrolment and providing individuals with more time to consider whether they wish to stay in the scheme. It may also increase the opportunity for the individuals to return the opt out form prior to deductions being taken from their salary, reducing the risk that refunds will have to be paid.

On the other hand a significant waiting period will reduce the total amount of pension saving, especially for those with many jobs in their working life.

5.3.2 Stakeholder views
There were strong and consistent calls to introduce waiting periods from employers, and also from many in the pensions industry. On the other hand, employee and consumer groups were generally opposed.

Employer groups support the introduction of waiting periods because they reduce the administrative cost and burden of enrolling people who are only with the employer for a short period of time and also allow probationary periods to pass before automatically enrolling individuals. They believe that waiting periods will help employers to adjust to the additional cost of the duties; that it will minimise the need for refunds; and would help reduce the risk of levelling down. It was also suggested that a waiting period could align with the Agency Workers Regulations 2010 and hence could ease agency burdens. Most stakeholders had a waiting period of at least 12 weeks in mind.

Some pension industry members and representatives supported waiting periods for similar reasons (the reduction in administration associated with short-term workers and also to reduce the need to administer small pots of pension saving) and recommended a three month waiting period.

Consumer and employee representatives were concerned that introducing waiting periods will reduce overall pension saving, penalising those who change jobs frequently, and increasing the likelihood that individuals will opt out of pension saving.

5.3.3 Options

We have considered two options:

- Introducing a three month waiting period for all employees – suggested as an appropriate length by the majority of stakeholders who recommended a waiting period, and affecting around five per cent of employees (who have been with their current employer for less than three months).
- Introducing a six month waiting period for all employees – affecting around 10 per cent of employees (who have been with the current employer for less than six months).

In both of these options, we recommend retaining the option for the employer to automatically enrol staff at anytime during the waiting period. This is to ensure that flexibility is retained and that those employers who wish to automatically enrol staff straight away or sometime during the waiting period can do so.

5.3.4 Key findings

Impact on individuals

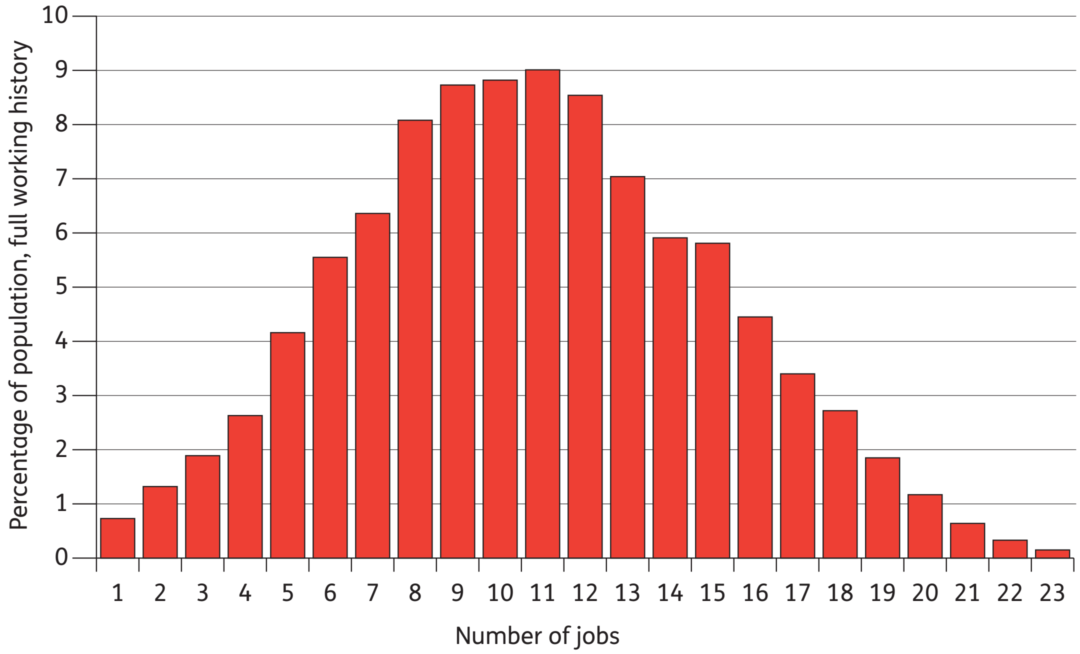
At any one time, an estimated 0.5 million or 0.9 million fewer individuals will be automatically enrolled into pension saving under these options and those that are automatically enrolled will not have contributed to a pension for the initial three months or six months they spend with any employer during their working life which will reduce their overall savings pot, unless they have opted in.

Chart 5.1 shows that, on average, an individual has 11 different labour market interactions during their lifetime[76] (the number of different jobs an individual has with different employers). Around 25 per cent of individuals have 14 or more employments. Therefore:

- A three month waiting period would have the effect, on average, of reducing an individuals accumulated years of saving by nearly 3 years (if all employers operate such a waiting period).
- Six month waiting period reducing years saved by 5-and-a-half years, on average.

76 The analysis in Chart 5.1 is based on individuals with full working histories, all individuals aged between 16 and 25 in 2007, the simulation start year.

Chart 5.1: Distribution of total number of jobs an individual will have over their lifetime, full working history



Notes: The analysis is of those who reported job transitions in a range of surveys. Therefore it is likely that the sample group will include those who were self employed and agency workers. The analysis measures discrete job moves between different employers.
Sample size: 7473.
Source: Department for Work and Pensions modelling using the GB Pensim2 model.

It is not possible to identify individuals who remain on short term contracts for the duration of their working life and so for whom this option would have the greatest impact. However, as a proxy, we can look at individuals with full working histories who have had over 20 different labour market interactions.

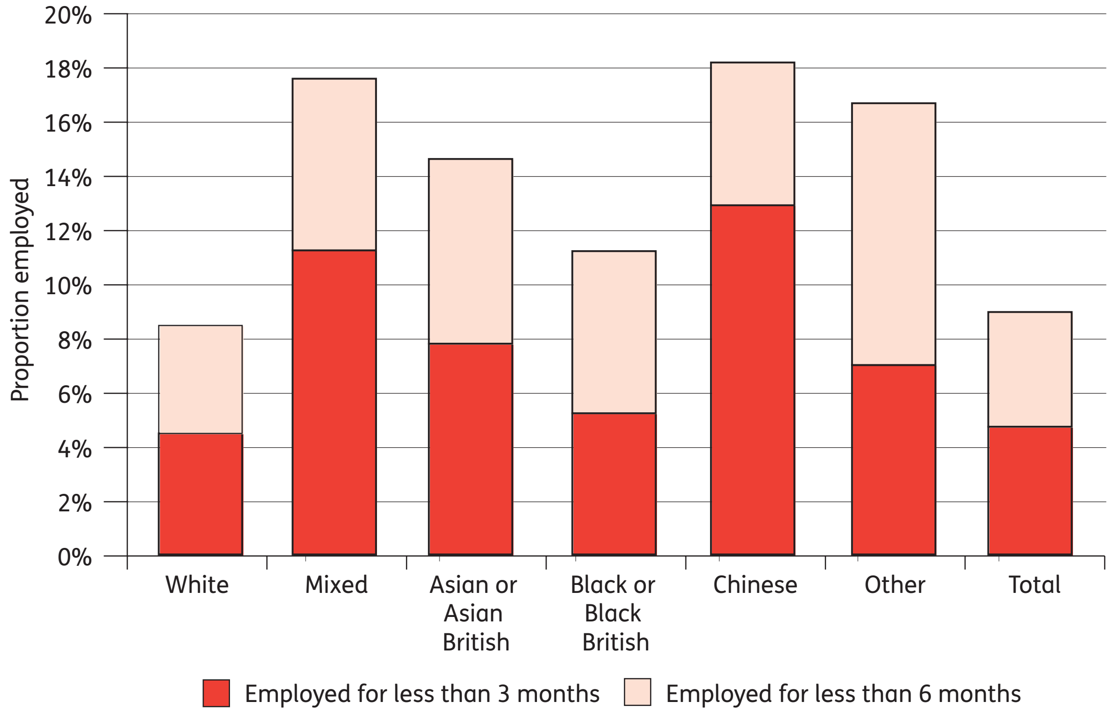
Of those individuals with a full working history, 2.4 per cent will have 20 or more jobs (which is an average job length of two years). A six month waiting period would reduce these individuals' accumulated savings by up to 10 years or more, whereas a three month waiting period would have impact of reducing these individuals' savings by up to five years or more[77]. So for those individuals that have the most frequent job changes, this may have a significant impact on their overall pension savings. (See Annex C.4.3 for further analysis on length of employment spells). Allowing individuals to opt into pension saving during the waiting period would, however, allow earlier access to those who particularly value it.

There appear to be minimal gender differences in rates of job churn. Nine per cent of employed men and nine per cent of employed women (in the target automatic enrolment population) had been in a current job for less than six months in 2007[78]. However, Chart 5.2 shows a greater proportion of non-White groups are employed for less than six months with eight per cent of employed White people having been in work for less than six months and 14 per cent of non-White individuals having been employed for less than six months.

77 Department for Work and Pensions modelling using the GB Pensim2 model.
78 Source: Labour Force Survey, United Kingdom 2007, Office for National Statistics. All figures relate to the current automatic enrolment target group.

On the other hand disabled people tend to have been in work for more time than non-disabled people. Only seven per cent of those employed and classified as disabled under the Disability Discrimination Act (2005) have been in work for less than six months, compared with nine per cent of the non-disabled population.

Chart 5.2 Proportion of eligible group in work for three and six months, by ethnicity



Note: Sample sizes for "mixed," "Chinese," and "other" are less than 50.
Sample size: 7,624.
Source: Labour Force Survey, April-June 2007, Office for National Statistics.

Young people are also likely to move jobs relatively frequently, whilst those starting a job aged 30-34 are likely to stay with that employer for longer. 24 per cent of 22 year olds have been in work for less than six months, which may reflect the large numbers starting their first job after leaving university. (See Annex C.4.3 for further analysis on job churn and age).

One potential concern is that introducing waiting periods might increase opt out rates as people become accustomed to receiving a wage without pension contribution deductions during a waiting period and feel a greater impact of pension contribution deductions once automatically enrolled. There is limited evidence available to help us understand the likely effect of waiting periods on opt out rates. What evidence there is from the US where schemes already operate waiting periods of up to 12 months shows that take up rates are still high and waiting periods do not seem to adversely affect opt out rates[79].

79 Fidelity International.

Impact on employers

The major benefits to employers of introducing waiting periods are the reduction in administrative burden and contributions costs (see Table 5.3). DWP modelling suggests ongoing annual savings on administration costs of at least £3m and £5m for three month and six months respectively (total administration costs are currently £127m) and an estimated £130m and £260m saving in contribution costs (total contribution costs are currently £3,240m). The administration cost savings do not seem all that high since employers are still having to meet the fixed costs associated with the duties, such as setting up a scheme, even though a waiting period will reduce the cost associated with other specific elements of the process.

The construction, distribution, hotel and restaurant industries exhibit a greater average job churn and so these industries are likely to benefit more from a waiting period. Micro employers in particular will benefit from having a waiting period because they have the highest levels of employee churn – 17 per cent of employees have less than one year's tenure (see Chapter 3). Employment agencies would also benefit from this with 11 per cent of workers temping for under two months and a further 21 per cent for two to six months[80].

Impact on the pensions industry and the Exchequer

The effects on the pensions industry are likely to be positive. There will be fewer small pots to administer, improved persistency of pension saving and a reduction in the administration of refunds where an individual would have opted out. The benefit of this to providers is reduced cost, which may result in increased profitability or a reduction in charges for members. This reduction in charges could offset the overall reduction in pension saving that a waiting period may create. The Exchequer saves an estimated £80m and £170m from reduced tax revenue foregone.

Table 5.3: Impact on employers and individuals of waiting periods

	Individuals			**Employer costs**	
Waiting period	**Total coverage**	**% female**	**Other characteristics**	**Contribution costs**	**Administration costs**
0 months (baseline)	10-11m	38%		£3,240m	£444m year 1 £127m ongoing
3 months	-0.5m	37% (of the 0.5m) No change to existing target group	Tend to be younger; no particular effect on disabled; slight adverse effect on ethnic minorities; no disadvantage as individuals retain right to opt in.	-£130m	-£5m in year 1 -£3m ongoing
6 months	-0.9m	39% (of the 0.9 m) No change to existing target group		-£260m	-£9m in Year 1 -£5m ongoing

Source: Department for Work and Pensions modelling.
Labour Force Survey, April-June 2007, Office for National Statistics.

80 REC Key Recruitment Trends 2007.

5.4 Excluding smaller employers

5.4.1 Why consider change?

The automatic enrolment duty currently applies to all employers who employ 1 or more individuals. Of the 1.2 million employers covered by the reforms, around 800,000 have fewer than five employees and 192,000 only have one employee. Very few of these currently offer any form of pension provision for their employees (five per cent and eight per cent respectively) and so will be undertaking new roles and processes in order to comply with the reforms.

Including smaller employers, therefore, involves engaging a very large number of employers in automatic enrolment for a comparatively smaller proportion of employees. The regulatory burden is proportionately higher for smaller employers than it is for larger employers. And the overall cost per worker enrolled is much higher, especially when the costs of the Pension Regulator are factored in.

Given these considerations, we have had to take seriously the case for change. Any case for change will, however, have to be set against the impact on those employed by small employers.

5.4.2 Stakeholder views

Most stakeholders suggested that all employers should be covered by the reforms irrespective of size. They felt that the existence of NEST meant that it would be possible for small and micro employers to automatically enrol their staff. Some were concerned that excluding certain groups of employers would lead to a distortion in competition. Concerns were also raised about creating disincentives for small employers to expand. Consumer groups generally felt that the scope for automatic enrolment was right and excluding particular groups of employers would be unfair to the individuals who work for them.

There was, however, some recognition that the reforms could be difficult for the very smallest employers. In particular, some employer groups representing small employers wanted the smallest employers to be excluded. One particular issue raised by consumer groups was that the duties will bring costs to disabled employers who employ carers.

5.4.3 Options

We have looked at the impact of removing three different groups of employers the automatic enrolment duties:

- Employers with one employee (for example those employing a nanny, cleaner or carer) – these employers are likely to face the greatest costs and difficulties complying with the duties.
- Employers with four or fewer employees – these employers will face higher costs-per-employee of automatic enrolment than larger employers.
- Employers with 19 or fewer employees – these employers are the least profitable employers for the pensions industry. Chapter 4 explains the very strong positive association between the number of employees in a company and the likelihood that a company scheme will be profitable at charge rates we feel are acceptable. There is some levelling off of this relationship for firms with around 20 employees.

The logic of any reform would be that employees of these small employers would not have the option to opt into pension saving in the same way as those who earn less than qualifying earnings. Otherwise much of the benefit to small employers and the Pensions Regulator could be lost.

5.4.4 Key findings

Impact on individuals

Excluding smaller employers under the three options outlined will see 0.3m, 1.5m and 3.4m fewer individuals being automatically enrolled at any one time (see Table 5.6). In general, people only spend part of their working life working for small firms and therefore will go onto work for larger employers and be automatically enrolled. Table 5.4 illustrates the overall movement of employees who work for smaller employers over a 10 year period. (See Annex C.4.4 for further details).

Table 5.4: Overall movement of employees working for a smaller employer over a 10 year period

			Column percentage
Moves between employers	**Employer size in 1997**		
	one employee	**4 or fewer**	**19 or fewer**
None	32	44	54
1	64	49	38
2	2	5	5
3 or more	2	2	3
Base	*1,466*	*6,170*	*20,500*

Source: Annual Survey of Hours and Earnings, Great Britain 1997-2006, Office for National Statistics.

However, for the period of time an individual works for a small employer, they will not contribute to pension saving or receive the benefit of having an employer contribution and tax relief towards their pension saving, which will affect their overall income in retirement.

If we consider a median earner who works for a micro employer from age 25-29 and then works for a larger employer until they retire, this individual will miss out on five years of private pension saving. This reduces their weekly pension income by £4 a week, from £225 to £221, and reduces their net replacement rate from 51.5 per cent to 50.7 per cent. This individual's lump sum would also be reduced by £2,200 from £18,800 to £16,600. The impact would obviously be greater for those spending more time working for a small employer.

Impact on employers

There are very different groups among micro employers. Some are self employed people employing just one or two additional staff. Some are simply people employing nannies or carers. Others are running more substantial small enterprises looking to grow.

The major benefit of this option is that it entirely removes the costs associated with automatic enrolment for the smallest employers – bringing annual contribution savings for the three options of £80m, £380m and £960m, and ongoing annual administrative savings of £16m, £63m and £93m respectively, as shown in Table 5.5.

However, exempting some employers from the duties based on their size can create three problems:

- There are likely to be practical implementation problems in identifying and keeping track of employers of very specific sizes, which may make it hard to get clear messages to employers and make ensuring compliance more difficult.
- There may be some distortions in competition if small employers face lower costs than their slightly larger competitors.
- There are possible perverse incentives which could inhibit business growth. Where an employer takes on extra staff they will face a cost 'cliff edge' of having to then automatically enrol all their staff. (See Box 5.1). Whilst we are not aware of evidence to suggest that the introduction of other regulations based on employer size, including health and safety risk assessments, and union recognition rights has stopped businesses from growing, the additional direct contribution and administration costs of this policy might well have such an effect[81]. As Box 5.1 shows the additional costs in moving from four employees to five could easily exceed £1,500 annually on top of the new employee's salary.

Box 5.1: Automatic enrolment costs associated with moving from having four to five employees

If employers with four employees or fewer are excluded:

- The cost to an employer of taking on a fifth employee would be the administrative cost of automatic enrolment and the cost of contributions for all five employees. The administrative cost would be around £420 in the first year and £230 per year in subsequent years. The three per cent employer contribution for the four employees assumed not to opt out would therefore cost the employer around £1,560 per year (given average qualifying earnings for individuals working for micro employers and not currently saving in a workplace pension are around £13,000).

If all employers are included:

- If the employer with four employees already had an automatic enrolment duty, taking on a fifth employee would have resulted in a marginal increase in administrative costs plus an increase in contributions of £390.

81 Information received from Department for Business Innovation and Skills.

Table 5.5: Costs and therefore potential savings to different sized employers

	Employer costs		
Excluding employers	**Contribution costs**	**Admin costs**	**Admin costs per employee**
Current employer scope	£3,240m	£444m in Year 1	£43 in Year 1
		£127m ongoing	£12 ongoing
1 employee	-£80m	-£41m in Year 1	-£140 in Year 1
		-£16m ongoing	-£53 ongoing
4 or fewer employees	-£380m	-£164m in Year 1	-£121 in Year 1
		-£63m ongoing	-£46 ongoing
19 or fewer employees	-£960m	-£278m in Year 1	-£86 in Year 1
		-£93m ongoing	-£29 ongoing

Source: Department for Work and Pensions modelling.

Table 5.6: Impact on Individuals

Excluding employers	**Total coverage**	**% female**	**Other characteristics**
Current employer scope	10-11 m	40%	
1 employee	-0.3m	39% (of the 0.3m) 42% in revised overall target group	No disproportionate impact
4 or fewer employees	-1.5m	41% (of the 1.5m) 42% in revised overall target group	
19 or fewer employees	-3.4m	41% (of the 3.4m) 42% in revised overall target group	

Source: Department for Work and Pensions modelling.
Annual Survey of Hours and Earnings, Great Britain 2009, Office for National Statistics.

Impact on the pensions industry and the Exchequer

The pensions industry currently has little engagement with the smallest employers and that is not expected to change a great deal in the face of automatic enrolment. We would expect the large majority to make use of NEST. Excluding micro employers means excluding the least profitable segments of the employer population, leaving the pensions industry better placed to meet the demand created by automatic enrolment. This is explained in more detail in Chapter 7. Annual steady-state savings to the Exchequer because of reduced tax revenue foregone is around £80m, £380m and £620m respectively.

The programme

About two thirds of employers are micro employers. So removing them from the scope of the programme would lead to a cost saving to the Pensions Regulator of over 45 per cent in operating the employer compliance regime.

Either option might create communication challenges as it would no longer be the case that all employers are being treated in the same way and, therefore, able to receive the same messages. It is possible that some employers would seek to evade the duties by setting up additional PAYE schemes or splitting in two once they reach a certain size. Exclusion of a particular band of employers may also increase both accidental and deliberate non-compliance.

Removing micro employers from the duty to automatically enrol would also generate short-term cost savings for NEST, although savings in steady state would be minimal.

5.5 Excluding older workers

5.5.1 Why consider change?

In the early years of the reforms some older workers, principally those without previous pension saving, who are automatically enrolled may receive a lower payback on contributions than younger workers due to the reduced time that they have before retirement to pay in contributions and receive growth on investments. Excluding those who are over 55 when the duties are first implemented may reduce the chances of some from losing out due to interactions with means-tested benefits in retirement.

5.5.2 Stakeholder views

In our recent consultation, views were mixed. Consumer and employee representative groups opposed exclusion saying it would not be aligned with the Government's intentions around extending working life and an increase in State Pension age. There was limited appetite for excluding older workers amongst employer groups. There was some support from industry with some calling for an exclusion of those that were 55 or over in 2012. All three groups expressed some concerns that it might not pay to save for those nearing retirement and that this could be addressed by providing targeted advice and information to these individuals to inform a decision to opt out of pension saving.

A number of consumer, employee and industry representative groups support the lowering of the age threshold to align with the National Minimum Wage, with several stating that the age could go lower to support greater savings throughout life. Employer representative bodies had mixed views, some support an alignment on simplicity grounds, but others are concerned about the increasing contribution costs and the need to enrol more individuals who only remain their workers for short periods of time. A similar number of stakeholders supported keeping the age threshold at 22. We concluded that the lower threshold is a balance between establishing patterns of saving earlier and avoiding automatically enrolling very young people with high labour market churn (e.g. those working in temporary jobs whilst in tertiary education), and that the current threshold of 22 strikes the right balance between these aims.

Some stakeholders also suggested that the upper age limit for automatic enrolment should be increased beyond State Pension age.

5.5.3 Key findings

Impact on individuals

Men dominate the group of eligible individuals who are over 55 in 2012. Analysis in Chapter 2 shows that 68 per cent of those aged 55 to State Pension age have some private pension wealth, rising to 79 per cent for those older people who are still in work and earning less than £40,000. The median pension wealth for these older individuals was found to be around £58,500. Chapter 2 also shows older people who are the lowest earners are least likely to have existing pension provision. An individual aged 55 in 2012 with median earnings is likely to receive a net replacement rate of approximately 48.7 per cent if automatically enrolled in 2012.

Unlike the other options discussed, excluding individuals aged over 55 in 2012 only has a temporary effect. This option will remove 1.1m individuals in 2012 from pension saving, but this number will fall during the following ten years, and there will be no effect on the eligible population beyond that.

The main benefit of excluding over 55s is to reduce their chances of losing out as a result of interaction with means tested benefits. However if we look at a median earner aged 55 in 2012 who contributes to a private pension until retirement, this individual will receive a private pension of £14.50 a week. He would lose income related benefits worth £2.50 due to this extra income, which therefore gives him an overall income that is £12 higher with pension saving. This saving increases his net replacement rate from 46.4 per cent to 48.8 per cent.

Many older workers will already have past savings and will benefit from topping up existing pension savings, which may take them above the thresholds for means tested benefits. Where older workers do not have past saving and only have time to build up a relatively small pension pot, they can trivially commute their pension pot, taking it all as a lump sum which, if it was under the capital limits, would have no negative impact on any benefit entitlement they have.

This option may see a disparity in approach between these reforms and the broader extending working lives agenda. The proposed phasing out of the default retirement age should see individuals working longer with more time available to build up pension saving.

Impact on employers

This option would see employers save £660m between 2012 and 2020 out of a total of £20,630m.

Impact on the pensions industry and Exchequer

There is a small beneficial impact on the pensions industry to the extent that some of the least profitable individuals are excluded temporarily, and that it prevents the build up of small pots. Total savings to the Exchequer are estimated at £370m up to 2020.

5.6 Conclusion

Table 5.7 outlines the impact on individuals, employers and industry for all options.

Table 5.7: The impact of target group options

Option	Individuals	Annual saving Employer	Industry
Earnings threshold			
£5,715	Minimal change	No change	Minimal change
£7,336	-0.6m	-£20m contribution -£3m ongoing	Benefits because least profitable individuals no longer saving
£10,000	-1.4m	-£50m contribution -£6m ongoing admin	
£14,000	-2.9m	-£250m contribution -£12m ongoing admin	
Waiting period			
3 months	-0.5m	-£130m contribution -£3m ongoing admin	Benefits – fewer small pots and improved persistency of pension saving
6 months	-0.9m	-£260m contribution -£5m ongoing admin	
Exclude some employers			
1 employee	-0.3m	-£80m contribution -£16m ongoing admin	Benefits – removes some of least profitable individuals
4 or fewer employees	-1.5m	-£380m contribution -£63m ongoing admin	
19 or fewer employees	-3.4m	-£960m contribution -£93m ongoing admin	High proportion of those automatically enrolled will be profitable
Exclude older workers			
Aged over 55 in 2012	-1.1m	-£660m (2012-2020)	Minimal change

Source: Department for Work and Pensions modelling.

Reducing regulatory burden 6

Summary

In this chapter, our aim is to identify a package of regulatory easements that:

- Are consistent with, and proportionate to, the achievement of the overall policy objectives.
- Do not introduce a level of change that, in itself, undermines employers' and the pension industry's ability to implement the reforms in a stable and measured way.
- Boost the credibility of the whole reform package in the eyes of employers and employees.

The main themes raised by stakeholders in proposing ways of mitigating the regulatory impact of the reforms were:

- The way employers are staged into the reforms during the four-year implementation process.
- The way individuals join the pension scheme and how opt-out works.
- Re-enrolment processes.
- How the definition of qualifying earnings impacts on employers.
- How to support smaller employers in complying with the new duties.
- The market restrictions placed on NEST.

This chapter considers each of these in turn. We concluded that there is scope for a number of deregulatory measures to be made, in addition to the measures discussed in Chapter 5 that have a deregulatory impact, including:

- **Allowing the largest employers to automatically enrol earlier than October 2012 if they wish to do so.**
- **Allowing increased flexibility around re-enrolment dates.**
- **A simple certification process to allow employers with good workplace pension schemes that use a different definition of pensionable pay to that in the Pensions Act 2008 to certify that their scheme meets the minimum standards required by the Act.**
- **Correspondence from The Pensions Regulator to micro employers should flag as strongly as possible that NEST has been designed to meet their needs and should facilitate easy access to NEST.**
- **DWP should look to provide maximum possible comfort to employers that they will not be held legally liable for their scheme choice, particularly if they opt for NEST or a stakeholder scheme to fulfil their new duties.**

6.1 Introduction

One of the central questions we address in this review is whether the regulatory burden associated with the reforms is both necessary and proportionate to the achievement of the policy aims. Throughout our engagement with stakeholders, we asked them to highlight areas where the regulatory burden was of concern and to suggest ways in which any unnecessary or disproportionate regulatory burden could be mitigated.

We also believe that the overall credibility of the pension reform package can be enhanced by the regulatory changes that we recommend, and that this will help the reforms to achieve widespread success.

In Chapter 3, we focussed on how the reforms impact on employers, explaining the processes they must undertake to fulfil their duties and highlighting where stakeholders have expressed concern about the extent of the regulatory burden that comes with this. In Chapter 5, we went on to consider the particular circumstances of small employers and whether there is a case for restricting coverage of the reforms to employers of a particular size. And in Chapters 4 and 7, we considered the costs, revenues and profitability of the pensions industry in supplying savings products to particular segments of the market under the new regulatory regime.

In this chapter, we consider the main themes raised by stakeholders in proposing ways of mitigating the regulatory impact of the reforms. These are:

- The way employers are staged into the reforms during the four-year implementation process (Section 6.2).
- The way individuals join the pension scheme and how opt-out works (Section 6.3).
- Re-enrolment processes (Section 6.4).
- How the definition of qualifying earnings impacts on employers (Section 6.5).

- How to support smaller employers in complying with the new duties (Section 6.6).
- The market restrictions placed on NEST (Section 6.7).

In looking at the each of the changes stakeholders proposed, we consider the balance of arguments of that particular change. However, the majority of stakeholders also told us that they are strongly in favour of retaining an October 2012 start to the implementation of the reforms. They saw this as important both to make an intervention as quickly as possible to tackle the consequences of demographic changes resulting from the ageing of the “baby-boom” generations, and because the current approach and timescales are backed by a broad consensus and already have a strong delivery momentum.

It is, therefore, also important that we consider the impact of any changes we might propose on the ability of employers and the pensions industry to implement the reforms in a measured and stable way. Both employers and the pension industry have a significant job to do in preparing for the implementation of the reforms and face lead-in times in developing new processes and systems to support the implementation of the new duties. It is critical that we do not undermine their ability to implement the reforms successfully by imposing too much change or by undermining the clarity of what it is they need to do to comply with the new duties.

So, in this chapter, our aim is to identify a package of regulatory easements that:

- Is consistent with, and proportionate to, the achievement of the overall policy objectives.
- Does not introduce a level of change that, in itself, undermines employers’ and the pension industry’s ability to implement the reforms in a stable and measured way.
- Boosts the credibility of the whole reform package in the eyes of employers and employees.

6.2 Staging

6.2.1 Allowing employers complete flexibility to choose their staging date

The new employer duties are due to be staged in over a four year period from October 2012, with 1.3 million employers brought in by size, from largest to smallest (any new firms coming into being after October 2012 will be staged in last) using PAYE scheme size as a proxy for employer size. Employers can bring forward their automatic enrolment date to a date earlier than their allocated staging date set by legislation, subject to approval by The Pensions Regulator. This earlier date must, however, be one of the staging dates set in legislation. All staging dates are on the first day of the relevant month.

Some employers have said that their allocated staging date may not fall at a convenient time for their business (for example, a retail company in the run-up to Christmas) and have asked for flexibility to choose an earlier or later date that is more suitable to them.

There are two key factors weighing against this proposal:

- There is a risk that financial pressures on employers would lead them to use such flexibility to put off the employer duties, delaying their workers access to pension saving and an employer contribution.
- It is likely to result in significant numbers of employers seeking to be staged in at the same time (for example, a significant proportion may come in at the end of the staging period or employers may be grouped around the start of the financial year). The Pensions Regulator and NEST have indicated that it is necessary for employers to be evenly spread across the staging period to ensure a stable take-on of employers into the reforms and that it would not be possible for them to manage significantly increased numbers of employers and individuals at any one point in time.

The proposal would also require changes to both primary and secondary legislation, delaying the point when policy certainty would be achieved. Although we do not believe this risk is significant, as it would be relatively easy to provide clarity on the proposed policy by making an early statement of intent.

Primarily on deliverability grounds, but also because our recommendation on a waiting period (see Chapters 3, 5 and 8) will allow greater flexibility over when an employer is required to automatically enrol their employees, we consider the existing flexibility to bring the staging date forward is sufficient and do not recommend this option is taken forward.

6.2.2 Allowing larger employers to automatic enrol earlier than October 2012

Not all employers will be able to enjoy the flexibility to bring their staging date forward, because there is currently no facility to automatically enrol before the October 2012 start date for the reforms. This means the largest employers (with 50,000 or more employees) who are due to be brought into the reforms on 1 October and 1 November 2012 have no or only very limited flexibility around their staging date.

Some stakeholders have suggested that these employers should be allowed to automatically enrol as early as 1 July 2012, if they wish to do so. This could bring approximately 450,000 employees into pension saving early, though we cannot be certain what proportion of these large employers will choose to automatically enrol early.

To allow early automatic enrolment, provisions of the Pensions Act 2008 would need to be brought in early, providing a statutory base for the compulsory deduction of contributions from wages and the passing of worker information to pension schemes.

In addition, to ensure that automatic enrolment into a workplace personal pension does not fall outside of the European Directives on Distance Marketing and Unfair Commercial Practices, a fully functioning compliance regime would need to be in place by July 2012. The Pensions Regulator is, however, confident that automatic enrolment from 1 July 2012 would be manageable, if it were only limited to these first two tranches of employers.

Similarly, NEST would plan to be ready in time if large employers were able to automatically enrol from July 2012, but the compressed timeline does bring some additional delivery risks. As this restricted early automatic enrolment would be voluntary, we believe this risk is manageable.

We recommend this approach.

6.2.3 Allowing employers to choose a staging date at any day in the month

Some stakeholders expressed concern that staging dates must be on the first of the month. They suggest allowing the employer the flexibility to choose the day of the month they automatically enrol, allowing staging dates to align with payroll cycles and avoiding the need for more complicated calculations of part-periods.

This proposal would also offer the opportunity for some employers to avoid paying a month's contributions for their workforce by moving the staging date until after their payroll run. However, the long term effects of this would be limited.

The proposal would also require changes to both primary and secondary legislation, delaying the point when policy certainty would be achieved, although we do not believe this risk is significant as it would be relatively easy to provide clarity on the proposed policy by making an early statement of intent.

We are attracted to this option and regard it as a sensible easement. However, our recommendation for a waiting period of up to 3 months will allow employers the flexibility they need to align enrolment with payroll cycles should they wish (see Chapters 3, 5 and 8). In the event that this recommendation is not accepted, we would suggest this option is revisited.

6.2.4 Introduce a common staging date for agencies

Stakeholders involved in the employment agency sector have raised concerns that agencies will be disproportionately disadvantaged by the current staging profile. They are concerned that the effect of the costs of automatic enrolment, even during the staging period where the minimum employer contributions is one per cent of qualifying earnings, will be particularly pronounced in the agency worker market, as the wage costs of workers is the primary driver of the costs of supply. They argue that this will significantly affect the competitiveness of those agencies that are staged in earlier and have called for a common staging date for agencies.

We are concerned that this proposal would not be deliverable in practice, both because of the difficulty in identifying all the businesses to which a common date should apply, but also because it would require a large numbers of individuals to be staged in at the same time. The Government estimates that there are between 1.1 and 1.5 million agency workers at any one time, with 1.3 million as the best mean estimate. Both The Pensions Regulator and NEST have indicated that it would not be operationally viable for them to deal with this number of workers at a single point in time. Under the current staging profile, for example, NEST is expecting to deal with no more than 200,000-300,000 individuals in any one month.

Some other sectors have also expressed concern about the competition impact of staging and we have not seen evidence to support the view that competition issues will disproportionately affect the agency sector more than other sectors where labour costs are also a large proportion of total costs. Without such evidence, it is difficult to justify treating the agency sector differently.

6.3 Joining and opt out

6.3.1 Allowing individuals to opt out before they are automatically enrolled

Under the current plans, while automatic enrolment is compulsory, on-going membership of a pension scheme is not. Employees can “opt out” of pension saving during a period of one month from the day they become an active member of a scheme or the date they receive enrolment information from the employer (whichever is later), but they cannot opt out before they are enrolled. Any pension contributions paid by the employee must be refunded to those who opt out. DWP estimates that around 25 per cent of individuals will opt out after automatic enrolment during this one month period.

Employer and industry representatives have expressed concern about the costs associated with the opt-out and refund processes, and employers have also expressed concern about the damage to employer-employee relations by enrolling individuals who know in advance they do not intend to stay in pension saving. They have suggested that allowing employees to opt out before automatic enrolment would tackle these problems, reducing the costs associated with enrolment and making refunds to those who do not want to save and opt-out. If introduced, this provision could also be extended to the automatic re-enrolment processes.

This proposal would most easily be implemented in conjunction with a waiting period (see Chapters 3, 5 and 8). This would allow individuals to be contacted during the waiting period and given the opportunity to opt out before they are automatically enrolled. The proposal would be more difficult in the absence of a waiting period, as there would be more limited time between an individual starting a job and the requirement to automatically enrol coming into effect. This would mean the benefits of this option are more likely to be realised by employers with a monthly payroll, than those who pay weekly. Opting out of automatic enrolment could, however, be allowed from the point that an individual is given information on the pension scheme, potentially before they join the company.

Having considered this option, our first conclusion is that, even if it were implemented, it could only be used to supplement, and not replace, an individual’s right to opt out after enrolment, as it would still be necessary to allow people to opt-out once they have seen the effect of the pension contributions on their first pay packet.

Impact on employers and providers

The proposal would have a limited impact on the administrative burden for employers, as they would still need to undertake a number of activities with each individual, for example identifying the jobholder, considering if they are eligible for automatic enrolment and providing them with information (Chapter 3 has a fuller description of employer processes). They would, however, have to enrol fewer individuals and process fewer refunds. The cost of enrolling an individual and processing an opt-out and refund is estimated at £14 per person for a micro employer and £7 per person for a large employer.

Pension providers would also not have any dealings with individuals who opt out before automatic enrolment, providing them with an administrative easement.

Impact on saving

While evidence of the impact on individuals' savings behaviour is limited, allowing individuals to opt out before automatic enrolment risks greater numbers of individuals being excluded from pension saving. This would happen if, for example, a significant reason for opting out is a disproportionate fear of managing the processes of being in a pension scheme or of the net impact of pension contributions on pay. The current policy approach means that individuals complete the enrolment process and see the impact of contributions on net pay before making a decision about continuing to save. With tax relief, and with an employer contribution bolstering pension saving, they may find that the impacts are less dramatic than they feared and the rewards of saving greater.

However, if inertia alone is the primary driver behind a decision to save or not, allowing early-opt-out would have a lower impact on opt-out rates, as the process involved would still require an individual to make a conscious and active decision to opt out.

Automatic enrolment is the lynch-pin of the proposed package of pension reforms. We have sought evidence from stakeholders who have experience, both in the UK and abroad, of how automatic enrolment works in practice and how take-up rates are affected by alternative implementations of the automatic enrolment concept. We did not find evidence to satisfy ourselves that allowing people to opt-out before joining would necessarily detrimentally affect opt-out rates, but we are also alert to the dangers of well-meaning changes undermining the desired behavioural outcomes of automatic enrolment.

Impact on the Employer Compliance Regime

This option will require change to the regulations that require employers to provide information to employees on their enrolment duty and right to opt-out. It would complicate The Pensions Regulator's compliance activity, as The Pensions Regulator would need to ask for additional information about numbers of opt-outs at employer registration to cross-check employers' information with information held by pension schemes and HMRC. More problematic is the ability of The Pensions Regulator to detect employers who declare high levels of opt out and enrol only a few, if any, jobholders. Under current proposals, schemes will be required to keep a record of the fact that an individual opted out and the date on which the employer informed them of this. Schemes may still be aware of some opt-outs, but not those that occur prior to automatic enrolment. This removes the ability that The Pensions Regulator currently has to cross-check the information provided by employers with pension providers employer registration.

Stakeholder reaction

As we could not recommend this option without continuing to allow employees to opt out once they have seen the impact of pension contributions on pay, the potential reduction in regulatory burden may be more limited and may reduce, but probably not eliminate, the enthusiasm amongst employers and the pensions industry for a change of this nature. Employee and consumer representatives may perceive this change as undermining the concept of automatic enrolment which, with mandatory employer contributions, is a key pillar of the reforms. They may react strongly, potentially undermining the broad consensus behind the reforms.

Legislation

This option would require very significant changes to the legislation behind the reforms. This is because the Pension Act 2008 is structured around the principle of automatic enrolment coming before any right to opt out. As well as prescribing a new opt-out period, changes would be required to the content and timing of the provision of information to employees, who it goes to, when and how the automatic enrolment duty applies.

Changes of this nature would entail a significant re-write of the Pensions Act 2008, with secondary legislation unlikely to be complete before the end of 2011. This would result in reduced legislative certainty across a broad area of the reform package. As the law would essentially be restructured, it is not as easy to mitigate the lack of clarity this delay in completing legislation would bring via an early statement of policy intent. Introducing this change would therefore reduce the clarity and certainty that employers and the pensions industry would have in preparing for the introduction of the reforms.

We were sympathetic to the intention behind this proposal. However, having weighed up the additional risks to individuals, and to the programme as a whole in implementing the reforms, our conclusion was to not recommend that it be taken forward.

6.3.2 Making opt-out easier for individuals: opt out form provided by employers

Employees have one month to opt out after automatic enrolment. Regulations currently require that the opt-out form is obtained by the individual from the pension provider, except where the scheme delegates the administration of the scheme to the employer in the trust deed. Schemes are able to provide this form electronically or with hard copy. Some stakeholders have suggested that all employers should be able to provide the form to the employee. This might be simpler, from an individual's perspective, as it would not require contact outside the workplace.

This proposal may lead some employers to feel that they are in some way required to advise jobholders. Employers could become conflicted, as what might be a good course of action for an employee, to remain in the pension scheme, may be a costly outcome for the employer in terms of the mandatory contributions. There could also be an increased risk of employers encouraging or coercing an employee to opt out if the employer can distribute the forms. In addition, it potentially reduces the activity an individual must undertake to opt out, making it more likely that opt-out is seen as the default act, rather than a proactive decision not to save for retirement.

There is considerable merit in maintaining some distance between the employer and the opt-out decision. Employer pension contributions are now a statutory right for employees, yet new employees often feel the least comfortable at asking for their rights and are the most susceptible to pressure from their employer. Keeping the opt-out form separate from the employer will avoid the risk of even well-intentioned employers accidentally creating an atmosphere in which a new employee feels that opting out would be a good thing to do for the finances of the business they have just joined.

An alternative would be for opt-out forms to be available from a central source, such as a link on Directgov or the DWP website. From an individual's perspective this option is not greatly different from sourcing the form from a pension schemes, although it would bring new costs to government to provide for the website capacity required.

Our concerns here are two-fold. First, processes should be designed to ensure an individual makes a considered decision before opting out of pension savings, but, second, once an individual has decided that saving is not appropriate for them, the processes should not be so onerous as to dissuade them from opting out. To inform our thinking on where the best balance lies, we asked to see NEST's prototype opt-out processes. Having done so, we concluded the process, which can be completed by internet or by telephone as well as by paper, will be sufficiently straightforward both for employers using the scheme and for individuals who have made the decision to opt out. For this reason, we do not consider that a change to the source of the opt-out form would considerably reduce the burden on employers and is not necessary to support opt-out by individuals who have made a decision not to save.

6.3.3 Other issues raised by stakeholders on opt-out procedures

Under current plans, the opt-out notice must include information about the implications of opting out. It was suggested that there should be greater flexibility about the content of this form. Having considered this, we do not believe the information included in the opt-out form should be simplified or removed. The decision to opt-out should be a considered one with the jobholder being given a full opportunity to understand the consequences of opting out.

The opt-out form is returned directly to employers under current regulations. This enables the employer to cease deductions with immediate effect and inform the scheme so that any contributions paid can be refunded. It was suggested that individuals should return the form to the scheme or a central processing point. However, from an individual and employer perspective there does not appear to be much benefit from these changes, as the employer would still require the information quickly to cease payments.

Some stakeholders have suggested that the overall period for joining and opt-out is too tight. We have addressed these concerns, at least in part, through our recommendations on a waiting period (see Chapters 3, 5 and 8) and do not consider there is significant additional benefit to be gained from further changes to the opt-out processes.

6.4 Re-enrolment

6.4.1 Removing the requirement to re-enrol individuals

The current approach requires that, on the third anniversary of their staging date, employers automatically re-enrol those of their workers who have opted out or left pension saving. The rationale behind this is that individuals' circumstances may have changed and they may now wish to take advantage of pension saving. As with the main automatic enrolment duty, individuals can not opt out before they are automatically re-enrolled. However, workers who have opted out within the previous 12 months are exempt from re-enrolment. Employers have the flexibility to choose the day in the month that automatic re-enrolment must happen, provided it is within one month of the third anniversary of their staging date.

Employer burden

While there is broad support from stakeholders for the concept of re-enrolment, some employers and industry representatives have expressed concern about the associated costs. The cost of re-enrolling an individual and processing opt-out and refund is estimated at £14 per person for a micro employer and £7 per person for a large employer.

Stakeholders were concerned that these costs are disproportionate given those being automatically enrolled will be individuals who have already chosen not to save. Employers also expressed concern about the impact on employer/employee relationships of repeatedly enrolling an individual who has made clear they do not wish to save, especially in the light of an individual's ability to opt in to pension saving, should they wish to do so. There have consequently been some calls for the removal of automatic re-enrolment from the reforms.

It was suggested that, instead, employers could be required to periodically remind their workers of their right to opt in to pension saving, should they wish to do so. However, this proposal would have a limited impact on the administrative burden for employers, as employers will still need to undertake a number of activities with each individual: identifying the jobholder again, considering whether they remain eligible for automatic enrolment, contacting them and providing them with information. They would, however, have to enrol fewer individuals and process fewer opt-outs and refunds.

There would also be a cost saving to providers, who would have to deal with fewer individuals being enrolled who would immediately opt-out.

Impact on individual savings

Removing re-enrolment is likely to reduce the number of individuals enrolled into pension saving. DWP research tells us that individuals welcome the opportunity to re-consider their saving decision and that changes in personal circumstances (family or income) or perceived affordability may lead them to change their saving decision[82] Attitudes research confirms the value of re-enrolment. When asked whether they would stay in or opt out at re-enrolment 13 per cent said they would stay in pension saving and 42 per cent said that they would consider their circumstances at the time, with 46 per cent stating that they would still chose to opt out[83].

The extent of the impact on the numbers saving will depend on the number of individuals who do, in fact, choose to opt in of their own volition, but we believe, overall, this proposal would reduce overall levels of pension saving.

The Government has chosen the path of automatic enrolment rather than compulsion in recognition of the fact that it will not always be in people's best interest to save for a pension. However, people's circumstances and immediate priorities do change, particularly over the life-cycle of domestic family life. It is therefore quite likely that someone who opted out in favour of other pressing financial needs will find it right to save for a pension later on in life and so would benefit from re-enrolment.

82 Gray E, Harvey P and Lancaster J, 2008, "Why people may decide to remain in or opt out of personal accounts", Department for Work and Pensions Research Report No 551.

83 Bourne T, Shaw A and Butt S, 2010, "Individuals' attitudes and likely reactions to the workplace pension reforms 2009", Department for Work and Pensions Research Report No 669.

Compliance impact

Employers are required, under current plans, to register with The Pensions Regulator to demonstrate how they have met their duties. This involves providing information on the pension scheme used, the numbers of employers automatically enrolled, those already saving and those not enrolled because they were not eligible. The Pensions Regulator will use this as a tool to follow up non-compliance, and will check the information provided against other information such as HRMC data.

The Pensions Regulator regards re-registration at the time of re-enrolment as essential to maintaining a culture of compliance amongst employers. While it might be possible to separate re-enrolment from re-registration, re-enrolment reminds employers of the duty to enrol eligible jobholders into a qualifying scheme and re-registration provides the check that they have done so, and requires them to sign a declaration to the effect that they are compliant. As well as giving employees who opted out in the past a further opportunity to consider pension saving, re-enrolment will also catch jobholders who for whatever reason were not automatically enrolled on starting work or when they became eligible for enrolment. The Pensions Regulator believes that there will be an 'inevitable erosion of compliance' in the three years following the initial staging date and the requirement to register and re-enrol again will counter this tendency.

Overall, we concluded that some form of re-enrolment was necessary to the overall success of the reforms.

6.4.2 Extending the re-enrolment period to five years

As an alternative to removing re-enrolment altogether, some stakeholders proposed extending the timeframe from three to five years. While this would not entirely mitigate all the costs and impacts employers and the pensions industry are concerned about, it would limit them, while retaining a measure for capturing those individuals whose circumstances change.

However, similar arguments apply as to the removal of re-enrolment altogether. Because of the link between re-enrolment and re-registration, extending the re-enrolment period to five years would delay The Pensions Regulator's opportunity to obtain up-to-date information from employers by a further two years. This would weaken the compliance regime and any administrative easement on employers would be lost if ad hoc requests from The Pensions Regulator to employers were required to compensate for this.

Over time it will be possible to collect data on actual patterns of re-enrolment to form a more complete picture of the workload involved and the additional numbers who benefit from pension saving as a result.

Overall, we concluded that, as re-enrolment was necessary to support the reforms, re-enrolment at three years after staging appears, at present, to be the best balance between possible adverse effects on the compliance regime and the administrative burden on employers.

6.4.3 Allowing employers flexibility to choose their re-enrolment date

Under the current approach, employers have the flexibility to choose the day in the month that automatic re-enrolment is undertaken, provided it is within one month of the third anniversary of their original staging date. Some employers have expressed concern that re-enrolment follows their initial staging date too precisely, creating a requirement for activity at what may not be a convenient time for their business. They have suggested that employers have more flexibility in choosing a re-enrolment date, provided it broadly comes three years after the staging date.

One approach proposed was to extend the existing flexibility to three months before or after the third anniversary of the original staging date. Both The Pensions Regulator and NEST had some concerns about the operational implications if, for example, significant numbers of employers converged on a common date.

Overall, however, we concluded that this was a reasonable easement for employers without being a great risk to the deliverability of the reforms and recommend allowing employers three months flexibility either side of the required re-enrolment date.

6.5 Qualifying earnings

6.5.1 Calculating contributions on basic pay

Employers and their representative organisations are concerned that the definition of qualifying earnings used in calculating the minimum level of pension contributions will make complying with the new duties costly and difficult, and will create a risk that employers with existing provision will level down to the statutory minimum.

The scheme quality requirements set out in the Pensions Act 2008 aim to ensure consistency across all employers, setting a minimum level for total pension contributions of eight per cent (at least three per cent from the employer) of qualifying earnings. Qualifying earnings are defined as a band of gross earnings between £5,035 and £33,540 (in 2006/07 prices) and includes a number of variable pay items such as overtime, bonuses, commission and shift allowances.

However, currently most employers use a definition of pensionable pay that is calculated on ‘basic pay’, which does not include all the elements of pay included in the definition of qualifying earnings. In addition, contributions are usually calculated from the first pound of earnings, rather than over a defined earnings band. There is some variation across employers, for example in the definition of pensionable pay, since pension schemes are often tailored to the profile of the workforce and the company’s business model.

The use of basic pay and counting it from the first pound of earnings are now an entrenched part of the traditions of most pension schemes. Upsetting those traditions carries a risk that employers, who may be under financial pressure in the current economic situation, will use the need to change their pension scheme as an opportunity to reduce their contributions down to the statutory minimum.

Employers with existing workplace pension provision will often have a payroll system that is designed to calculate contributions on basic pay. Feedback from employers and their representatives suggests that requiring employers to calculate their contributions on qualifying earnings may involve costly and complex system changes. In addition, contributions are generally stable because variable pay items are excluded. This makes it easier to communicate to members because their payslips will show the same regular amount of contributions being deducted. Where payment schedules are sent to the scheme setting out the employer and member contributions, the amount payable is predictable which makes it easier to monitor payments into the scheme.

This had led to the proposal, from the pension industry and employers, to move away from the current definition of qualifying earnings and allow contributions to be calculated on basic pay and from the first pound of earnings.

As discussed in Chapter 3, basic pay from pound one is at least as much as qualifying earnings for 92 per cent of jobholders. In 2009, 92 per cent of total pay was made up of basic pay with other components making up eight per cent overall. 83 per cent of eligible jobholders have basic pay which as at least 85 per cent of their total pay.

Impact on contributions

Moving to calculating pensionable earnings on basic pay from pound one has an impact on contribution levels. This could be off-set to some extent by changes to the overall contribution rate, but this would represent a significant change to the basic parameters of the reforms on which there is broad consensus and would not avoid the changes impacting disproportionately on some employers and some individuals.

With contributions levels where they are, switching to basic pay alone reduces total contribution levels by ten per cent, but when combined with taking contributions from the first pound, total contribution levels increase by 30 per cent.

Individual contributions would increase by around £1.2bn to £5.5bn per annum. The impact felt by individuals would depend on the proportion of basic pay to total pay used in their pay. Some individuals would pay more, while others would pay less. Where contributions increase, these are likely to be felt most keenly by lower earners, and the proposal would create a cliff-edge in contributions for those earning just above the eligibility threshold, which might potentially increase opt-out numbers. Equally, however, lower earners would see a proportionately higher increase in their pension pots from increased contributions.

Employer contributions would increase by around £940m to £4.2bn per annum, including an increase of £440m per annum in costs to small and micro employers. The impacts felt by individual employers would again depend on the proportion of basic pay to total pay in that organisation.

Tax relief costs would increase by around £370m to £1.6bn per annum, with overall exchequer costs increasing by £610m to £2bn per annum.

The use of band earnings disproportionately disadvantages low earners over medium earners, as the amount offset from pay before it ranks for pension contributions is proportionately higher. However, our work on replacement rates in Chapter 2 shows that the state pension system is providing proportionately more generous pensions for low earners. So when the combination of State Pensions and private pensions are taken together, the use of band earnings helps to even out the replacement ratios across the earnings spectrum.

Stakeholder positions

While some employers and employer groups have called for a move away from qualifying earnings, they may be less supportive if this resulted in significant increases in the minimum level of contribution costs. We believe that, if the statutory requirement were changed to base pension contributions on earnings from the first pound rather than band earnings, many employers would call for their contribution rates to be reduced. This would damage the strong consensus that has built up behind the Pensions Commission's original proposals.

Consumer and employee representative organisations are likely to be wary, welcoming increased levels of employer contributions but being concerned about the potential for some individuals losing out. They have also been concerned about the potential for employers to manipulate pay structures to reduce pension contributions.

The pensions industry is likely to support this change both on simplicity grounds and as it increases money going into pension saving.

Our conclusion is that, rather than changing the way minimum contribution levels are calculated, the issues raised by employers can be resolved by having a simple and effective certification process.

6.5.2 A simple certification process

An alternative to moving away from qualifying earnings would be to introduce an administrative easement for employers with defined contribution schemes. The Pensions Act 2008 (section 28) allows for such a process, known as 'certification'. This allows an employer to 'certify' that, overall, their scheme satisfies the relevant quality criteria for defined contribution schemes. This avoids the need for a detailed calculation to demonstrate that contributions in respect of every individual in that scheme met the minimum contribution requirement.

DWP has been working with employers, their representatives and the pensions industry to develop a certification process that will simplify the automatic enrolment duty for employers who calculate their pension contributions with a different definition of pensionable pay than qualifying earnings. This has involved working through an industry working group to develop a certification model, employer site visits and workshops. Feedback from employers suggests that they want:

- To retain their existing schemes as these have been developed over time to reflect their business model and workforce profile.
- To do the right thing by their workers by complying with the legislation.

- To continue to calculate their contributions on basic pay because large scale system changes are costly.
- A simple processes that does not require checking every single contribution record, as this can impose a huge administrative burden especially in the larger schemes.
- A process whereby, if changes in their pay structure mean that they become unable to re-certify, they are required to improve matters going forwards but are not required to make retrospective changes to pension contributions already made.

During conversations with employers on possible certification models they have said that, if they are required to make substantial changes, it may be simpler just to reduce their contribution rates to the statutory minimum ('levelling down', discussed further in Chapter 3). It is important that we do not present employers with this conundrum, especially given the current economic situation and the pressures employers face on costs.

The proposed certification model emerging form DWP's work with employers and the pensions industry uses the employer's pensionable pay from pound one. It is based on three steps. Employers check the scheme's contribution rate and:

- If the scheme provides for minimum contributions for each jobholder of at least nine per cent (four per cent minimum employer contribution), the employer can certify that the scheme meets the scheme quality test.
- If the scheme does not provide for a nine per cent contribution, but contributions for each jobholder are at least eight per cent (three per cent minimum employer contribution) and pensionable pay is at least 85 per cent of total pay, the employer can certify that the scheme meets the scheme quality test. The ratio of pensionable pay to total pay can be calculated as an aggregate across the scheme.
- If the scheme provides for a contribution of less than eight per cent but of at least seven per cent for each jobholder, and 100 per cent of pay is pensionable, the employer can certify that the scheme meets the scheme quality test.

If the scheme does not pass any of these tests then the employer would need to improve scheme quality going forward or carry out individualised checking. A certificate is expected to be based on one past year's data and to be valid for the following year. We understand that DWP will be consulting on the full details of this model later in 2010.

We believe that the approach underpinning this new certification model addresses the concerns raised by employers and the pensions industry because:

- Employers can continue to use basic pay to calculate their pension contributions.
- The new model recognises and rewards higher quality schemes.
- An early version of the model has been tested with employers and their representatives and has their broad support.
- The risk that individuals suffer significant detriment is strongly mitigated by the minimum level of contributions required under the model.

We have concluded that a certification model along these lines strikes the right balance between regulatory burden and protection for individuals. Our view is that the potential for levelling down as a response to a more precise, but more onerous, certification model would introduce a more significant risk of detriment for individuals, and we recommend that a certification model along these lines is adopted.

6.6 Supporting small employers

In Chapters 3, 5 and 8, we discuss the regulatory burden placed on employers as a result of the reforms and, in particular, the impact on smaller employers. Our conclusion was that all employers should be subject to the new duties, but we remain concerned about the difficulties small employers will face in complying with their duties.

Representatives of small employers have raised concerns both about the cost of compliance, but also that the smallest employers, who are unlikely to have much experience or knowledge of workplace pension provision, will find the requirement to choose an appropriate pension scheme onerous.

The pension reforms are being introduced at the same time as the Financial Services Authority is introducing its Retail Distribution Review(RDR). Stakeholders have told us that the RDR will have a major impact on the business model of small financial advisers, who traditionally have been the mainstay of providing financial advice to small employers. We cannot be certain that all small employers will have access to help and advice in choosing a suitable pension scheme to meet their statutory duties.

6.6.1 Flagging NEST to micro employers

Under the current approach, employers are required to choose which pension provider or scheme they use to automatically enrol their workers. They can choose to use NEST, seek a provider from the wider industry or set up their own scheme. However, some of the smallest employers may be unable to find a provider able to offer them a suitable scheme at an appropriate charge level, so the choice for many could be effectively limited to NEST.

As the smallest employers are likely to be least equipped to make a choice of schemes, but effectively have limited or no choice in any event, it has been suggested that micro employers be defaulted into NEST. However, this is not possible to achieve in practice. Effective membership of a pension scheme requires the active involvement of employers, for example in identifying qualifying workers and in passing the necessary information to the pension scheme, so cannot be achieved by default.

An alternative is for correspondence to micro employers from The Pensions Regulator to make clear that the design of NEST specifically takes account of their needs and that the scheme has a public service obligation to serve all employers who want to use it at a fixed charge level, and to provide contact details so that employers can access NEST easily. The communication would also state that the employer is able to use their existing scheme or another scheme if they wish and provide contact details for sources of information on the range of schemes available in the open market. This would reduce the need for micro employers to search for a scheme but leave them open to using other options if they choose.

Overall we recommend that Government should go as far as it can in making it clear to micro employers that NEST is an easy and appropriate choice for them.

6.6.2 Legal protection

Some employers and employer representative groups have suggested that the Pensions Act 2008 should include a 'safe harbour' provision, to offer employers protection from the risk of employee litigation in respect of either:

- Information provided by the employer or,
- The employer's choice of pension scheme or default fund.

There are concerns amongst some employers, particularly small and micro employers, that the employer may be sued by the employee if the chosen scheme or fund performs less well than others or if an employee loses out as a result of a decision based on information provided by their employer.

There is existing provision in the Pensions Act 2008 protecting employers from employee litigation if they do not meet the statutory duties set down in that legislation. The aim of that measure is to confirm that it is for The Pensions Regulator to take action in these cases. There is, however, no such provision, for circumstances in which employers do meet their statutory requirements.

We understand that the risk of an employer being found liable for automatically enrolling an employee into a scheme which underperforms is low and that the risks of employer liability around the provision of information to individuals are minimal and should be sufficiently mitigated by the information products and guidance being developed.

However, the issue for employers is not just the level of legal risk. The uncertainty about their potential legal liabilities, particularly amongst those employers who do not have experience or knowledge in this area, in itself raises concerns and difficulties for employers in complying with the duties. We believe, therefore, that there is benefit in providing employers with the reassurance of a level of legal protection. The requirements on employers in relation to stakeholder pensions, for example, stipulate that employers are not under any duty to check on the quality and performance of the stakeholder pension offered to their employees.

We recommend that Government explores whether there are ways of providing similar reassurances to employers choosing a scheme to meet their automatic enrolment duties.

6.7 NEST

6.7.1 The NEST annual contribution limit

Along with the restrictions on transfers in and out of the scheme, the annual contribution limit is designed to focus NEST on its target market of individuals not well provided for by existing pension provision, and ensure that NEST complements rather than replaces existing provision. It places an annual limit on contributions of £3,600 (in 2005 earnings terms, equivalent to £4,271 today).

There have been calls, from consumer and employee representative groups, and some employers, for the limit to be increased or removed. They are concerned that it reduces flexibility and increases complexity for both individuals and employers. NEST is also concerned about the complexity that administering the limit brings for them and for employers and employees who may fail to understand the reason for the cap and the likelihood and consequences of it being breached.

Current evidence shows that the majority of individuals do not save over the level of the limit. The Annual Survey of Hours and Earnings (ASHE) shows that almost two-thirds of members of defined contribution pension schemes have annual contributions of less than £3,000 and nearly four-fifths have contributions of less than £5,000. While it is not possible to predict accurately what will happen in the future, given that NEST is intended primarily for low to medium earners, it is unlikely that a large proportion of individuals in NEST will want to save above the limit in any event.

However, the limit does bring additional complexity. It necessitates employers and NEST making projections of contributions for each employee, to ensure they would not breach the limit. Significant changes in earnings during the course of the year could lead to some individuals breaching the limit, requiring a temporary halt in participation or a refund of contributions. The monitoring and refund processes add complexity and cost for both employers and for NEST.

Some employers and agencies have indicated that the existence of the limit and the costs associated with it may lead them to choose schemes other than NEST or prevent them from contributing more than the minimum level of three per cent for parts of their workforce without setting up a separate scheme. Raising or removing the limit would reduce or eliminate these risks.

We are also concerned that the existence of the cap sends an unhelpful message that retirement savings at this level may be enough. This may contribute to decisions by individuals to save less than they otherwise might, and less than they ought to maximise their lifetime welfare.

There is, however, concern amongst the pensions industry about removing the contributions limit at this point in time as they feel this will risk NEST's focus shifting away from its target market. The broad consensus behind the reforms and our own recommendation that NEST is needed is based on NEST's role being to fill the 'supply gap', that is those who the existing industry currently find it difficult to serve, complementing rather than replacing existing provision. The contribution cap limit, along with the restriction on transfers into NEST, is seen as a key lever in ensuring NEST remains focussed on this target market. Indeed, NEST's activity to date has clearly been targeted on the area of this 'supply gap'.

We understand the pensions industry's concerns that NEST remain strongly focussed on the target market as the reforms are staged. However, we think that there is a strong argument for removing the contribution limit once NEST is established and the reforms are bedded in. By that stage, employers will have selected their qualifying scheme and have their pension arrangements in place. Removing the limit at that stage is unlikely to result in large numbers of employers switching into NEST, while keeping the limit in place may act as a longer term constraint on individuals and employers who wish to make higher pension contributions on a voluntary basis.

We recommend that Government legislates now for the removal of the contribution cap from 2017.

6.7.2 NEST transfer restrictions

Current pension transfer regulations entitle individuals to transfer pension funds between pension holdings. However, in order to minimise market turbulence caused by the introduction of NEST, to smooth implementation and to ensure that the scheme remains focused on the target market, legislation currently prohibits the transfer of pension funds into and out of NEST except in a few strictly limited circumstances. Along with the contribution limit, a restriction on transfers is designed to ensure NEST complements rather than replaces existing pension provision.

There have, however, been some calls, mainly from consumer groups and some parts of the pensions industry, for the transfer restriction to be removed, in particular to allow pension pots to follow individuals as they change employment.

The restriction on transfers is a key element of the consensus underpinning the reforms. In particular, the pensions industry views the transfer-in restrictions as highly important in ensuring that, as employers are staged into the reforms, NEST is focussed on its role of filling the 'supply gap', rather than replacing existing provision. It is recognised, however, that the nature of this issue changes once the reforms are fully rolled out, and the Pensions Act 2008 requires the Secretary of State to review this policy in 2017.

Facilitating transfers is, in our opinion, critical to the success of the reforms. In a world where automatic enrolment makes pension saving a norm, including for low earners and people who move jobs frequently, there is a much higher risk that an individual's pension savings becomes fragmented in a number of small pots. The inability to easily see a complete picture of the extent of pension saving could act as a disincentive to save more, and having pension saving spread into a series of small pots may make it more difficult for an individual to access their savings on retirement. Our view is that, as pension saving in defined contribution schemes becomes the norm, so should moving and consolidating pensions saving alongside changes in employment.

However, this is an issue that goes beyond how transfer rules are applied to NEST. In the market more generally, transfers are restricted by frictional costs, including the cost of regulation and advice. In the past, that advice has been quite complicated, owing to the structure of final salary schemes and early defined contribution schemes that often carried guaranteed annuity options. But going forward, there is much greater commonality amongst employer sponsored pension schemes, and more to be gained than lost from taking accumulated pensions with you on moving employer.

Our conclusion is, therefore, that there needs to be more wholesale consideration of how transfers can be facilitated much more easily across the pensions market as well as in and out of NEST.

We recommend that Government undertakes a further review, in advance of the 2017 review of the restriction on transfers for NEST, to consider how transfers across the pension industry can be made easier, so that individuals are better able to consolidate their pension savings as they change employment over their working life. This work should ensure that, once the automatic enrolment duties are staged in, we can move quickly to a world where transfers between pension schemes on change of employment, including transfers in and out of NEST, become a more normal practice.

7 Private pension provision under changes to the automatic enrolment policy

Summary

In this chapter, we consider how changes to the target group for automatic enrolment would affect the ability of the existing private pensions industry to profitably supply a suitable pension product to a greater proportion of the target group. And we have analysed whether, if those changes were taken far enough, a reduced scope for pension reform could be carried out without needing to build NEST.

Our main tool in this exercise is a model of the profitability of workplace personal pensions to insurance companies. We believe that, in the absence of NEST, it must be possible for all employers who fall under a cut down version of the automatic enrolment duties to be able to find a commercial pension provider, most likely a Group Personal Pension or a Stakeholder Pension. This is not to preclude other options, and in the absence of NEST we might well see a number of industry-wide occupational pensions set up, but the key determinant of whether commercial pension providers will be prepared to cover the whole market is profitability. We feel that this applies irrespective of whether the insurer behind the Stakeholder Pension is proprietary or mutual in structure. In conducting this analysis, we have set the current stakeholder charge cap of 1.5 per cent for ten years and 1.0 per cent thereafter as the upper bound for charges. In doing so, we note that, at these charge levels, the costs to individuals in terms of lower pensions than they would achieve at NEST charge levels would be substantial.

Our conclusion is that the pensions industry could potentially provide pensions to the whole market only if automatic enrolment were drastically constrained, through some combination of a higher trigger point of between £10,000-15,000 annual earnings for automatic enrolment, exempting smaller employers and allowing a three month waiting period. Whilst it is hard to be precise, we would only be confident that NEST was not needed were employers with fewer than 20 employees and employees earning less than £15,000 a year excluded from scope.

There are other considerations to take into account when considering the correct scope for automatic enrolment, including the increases in overall pension saving achieved and the impact on individuals, both which individuals are brought into pension savings at all and the returns from savings for those that do save. These arguments are considered in the other chapters, especially in Chapter 5, and Chapter 8 brings together our overall conclusions.

7.1 Introduction

This chapter looks at potential changes to both the target group for automatic enrolment (discussed in Chapter 5) and the way in which automatic enrolment happens (discussed in Chapter 6). It considers whether such changes would make pension provision more profitable and attractive to private pension providers.

The Chapter first explains the assumptions behind our analysis and modelling, and, in Section 7.2.1, looks at stakeholder views on the effects of potential changes on profitability. In Sections 7.2.3 to 7.2.5, we look at the potential impact of individual changes in isolation, increasing the earnings threshold for automatic enrolment, excluding the smallest employers, reducing provider costs and introducing a waiting period. In Section 7.3, we consider the effects of combining these different options, and look at how far this would make the market profitable. We then look at how much further we might need to go in limiting the scope of the reforms in order to ensure a wholly industry-based solution to supply under automatic enrolment before pulling together our conclusions (Section 7.4).

We include a number of charts that show the proportion of employers that our model forecasts would be profitable for the existing pensions industry to serve. Where this proportion is substantially below 100 per cent, our modelling suggests that employers would face real problems in finding a pension provider to enable them to comply with their statutory duties. Where the proportion is close to 100 per cent, then we might more reasonably expect the market to provide complete coverage, as some providers may not recognise those employers as un-profitable and other providers may be keen to build market share and so be happy to write business on marginal terms.

7.2 Profitability and viability under changes to the target group or simplifications to automatic enrolment

This section discusses the impact of changes to the target group and regulatory environment on the pensions industry. There are a number of assumptions we need to make in order to understand the likely impact.

- The presence of NEST will have an impact on the pensions industry. Where analysis is presented on the basis that NEST does exist, we assume that NEST will operate as a form of “benchmark”, resulting in lower charges across the pensions industry. Whilst it is difficult to estimate what exact level this would stabilise at, we have chosen to model low-charge scenarios, based on the assumption of charges slightly above the level intended for NEST, using a 3 per cent contribution charge plus a 0.5 per cent annual management charge (AMC). Where analysis is presented on the basis that NEST does not exist, we assume that charges will be higher. The review team believe that it would be a backwards step to allow charges higher than the current Stakeholder Charge cap, so we have used that level as our high-charge scenario.

- The pensions industry is dynamic and responsive, but looks structurally broadly similar in 2012 to how it does now. In Chapter 4, we looked at options such as a pensions industry dominated by several master-trusts or the building of a carousel type infrastructure which would be used to collect and process contributions. The analysis in this chapter is based on a pensions industry in which there are many providers and an individualised, rather than collective, infrastructure.
- Policy changes could shift the balance between the respective roles for NEST and the existing pensions industry. Throughout the first section, we explore the balance of market share between NEST and the rest of the pensions industry under each of the policy options.

We have not included any assumptions about the impacts of the outcome of the Retail Distribution Review (RDR), since it is unclear what these are likely to be. On the one hand, the RDR will undoubtedly have an effect on the way in which intermediaries decide to sell schemes to employers and the transparency of their pricing. On the other, the RDR outcomes may not in fact result in significant changes in prices for members, since commission payments could be replaced with "consultancy charging" in many cases, which would still result in the member paying a certain proportion of their fund value in charges that go to intermediaries.

As discussed in Chapter 4, there are a number of factors that influence profitability, broadly grouped around the amount of contributions going in, how persistent those contributions are, charge levels and the costs providers incur in providing the pension. The impact of various changes to the target group and de-regulatory measures are set out under those headings.

7.2.1 Stakeholder views

The predominant view was that there would have to be major changes to the scope of eligibility, as well as significant regulatory simplification, for the pensions industry to have a chance of meeting the demand from automatic enrolment without NEST. Opinions of the precise changes required varied but typically involved a combination of:

- An increase in the earnings threshold to somewhere between £10,000 and £15,000 a year.
- The exclusion of small employers: from micro employers (1-4 employees) at one end of opinion, through a more typical 10-20 employees, to a top estimate of excluding all employers with fewer than 50 employees.
- A waiting period of three to six months.
- Significant regulatory simplification to reduce the cost of supply.
- Charges for some segments of the market to be higher than those offered by NEST – at around the current stakeholder cap, two or three times higher than the proposition offered by NEST.

Some stakeholders suggested alternative models to reduce costs or improve profitably and, hence, improve the proportion of the market that the existing industry were able to cover. They ranged from proposals for utilising existing capacity within the pensions industry or 'risk based schemes' to more detailed ideas, including using existing stakeholder schemes, online highly automatic group personal pensions, and hybrid models whereby NEST becomes an administrative hub between employers and providers. Some of these are discussed in more detail in Chapter 4.

Some stakeholders (including the Association of British Insurers) commented that, unless charges were allowed to reach high levels, it would be unlikely that the current industry could fill the supply gap in the absence of NEST even if parameters were changed. Some respondents said that there would always be a segment of employers for which private sector provision is unviable, whilst others felt they were simply unwilling to take on the risks associated with the least profitable market segments. Some provider representatives remarked that they would be unlikely to pursue business in the future that they were not currently interested in. There was also a feeling that even if industry-based alternatives to NEST were viable with changes to the scope of automatic enrolment, this would be unlikely to support a 2012 implementation for the reforms.

The overall picture was one of caution from the existing industry, with a strong sense that they may have more attractive opportunities to deploy their capital than taking a long term bet on the stability of the UK pensions scene. Indeed, a substantial number of industry respondents concluded that NEST was necessary to the reform programme.

7.2.2 Modelling

The remainder of this chapter primarily focuses on analysis that models profitability in the market under various scenarios. The model used, combines research data and assumptions on employers and their employees (numbers, salaries, contribution levels etc.) with research evidence on provider costs in order to calculate a "net present value" for each employer. This looks at whether a provider would be able to cover their costs in supplying to a particular size of employer at a given charge level. Further detail about the model is provided in Annex C.3.

There are some important caveats to bear in mind around this analysis. Whilst the model is sophisticated and based on reliable data from highly respected surveys, including national statistics, it obviously cannot provide a perfect representation of the real world. In particular, the cost basis uses a single set of assumptions for each employer size band, and thus does not capture all of the nuances in diversity across the market. For example, in terms of provider size, business model, attitudes to risk, and the services they provide. For these reasons these figures are best used as a comparison between options than to gauge the absolute profitability figures for any particular option.

That said, it is worth highlighting the congruity between the modelling and stakeholder views in terms of the changes needed to make the majority of the market attractive for providers to serve. The consistency with stakeholder views serves to reinforce the reliability of the modelling and vice-versa.

Chapter 4 highlights how important contributions levels are for industry profitability. Whilst none of the options we have looked at increase contribution levels directly (for example by increasing the minimum contribution rate), a number of them increase average contributions per member or per employer.

7.2.3 Contribution levels: changing the earnings threshold for automatic enrolment

Under current policy, the earnings threshold for automatic enrolment is £5,035 (2006/07 terms). This is the point at which employees will be automatically enrolled, and pension contributions will be based on their earnings above this.

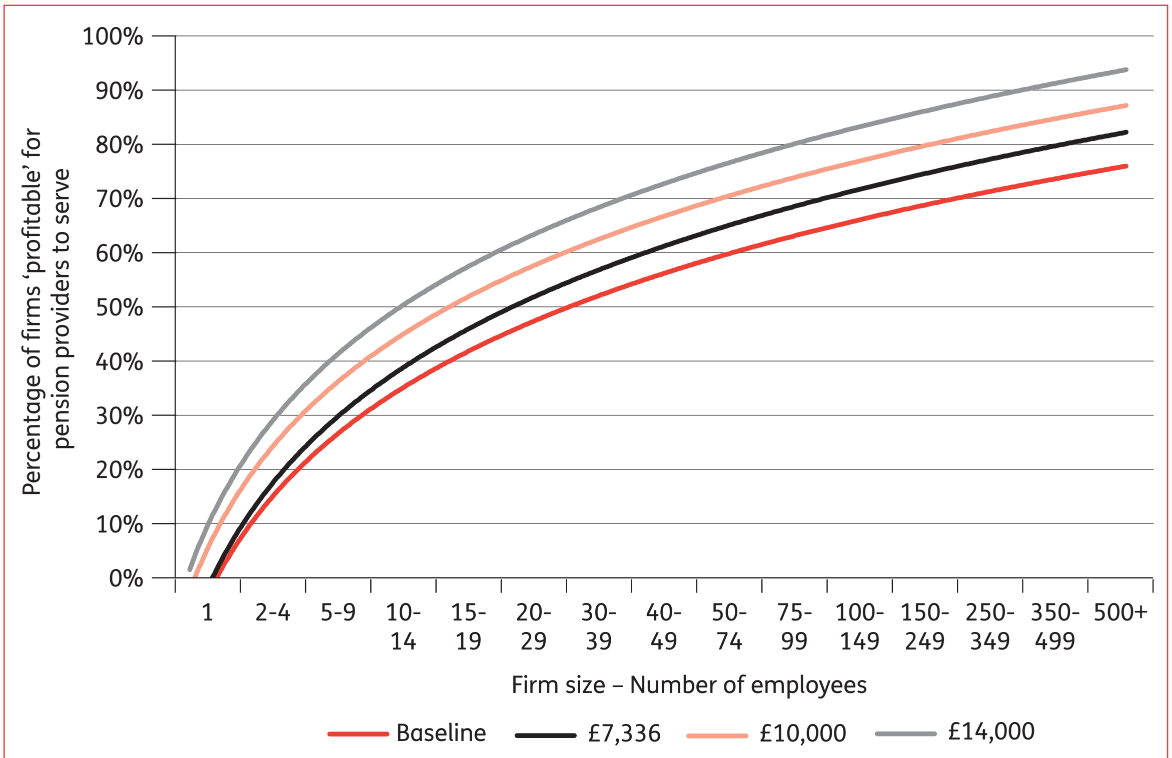
Increasing the earnings threshold for automatic enrolment, whilst still calculating pension contributions on earnings above £5,035, takes out some of the lowest earners who contribute the smallest amount, thereby increasing the average level of contribution. Industry stakeholder groups tended to support the idea of introducing this two-tier approach through increasing the earnings threshold at which automatic enrolment is triggered.

Profitability analysis under charges of 3 per cent contribution charge plus 0.5 per cent AMC

As Chart 7.1 demonstrates, increasing earnings thresholds increases profitability within the pensions industry, even under the scenario where charges are relatively low.

As we would expect, the higher the earnings threshold that triggers automatic enrolment, the more firms become profitable for pension providers. Higher earnings thresholds effectively 'filter out' many employees whose contributions will only build small funds (and therefore generate lower management charge revenues). This effect is significantly more pronounced in larger employers. A threshold of £14,000 produces the greatest increase in profitability. A threshold of £7,336 makes very little difference to profitability, since this represents a relatively small increase from the current threshold, and still allows individuals with very low earnings – and thus very low pension contributions – to be automatically enrolled.

Chart 7.1: Profitability under different automatic enrolment triggers, assuming 3 per cent contribution charge plus 0.5 per cent AMC

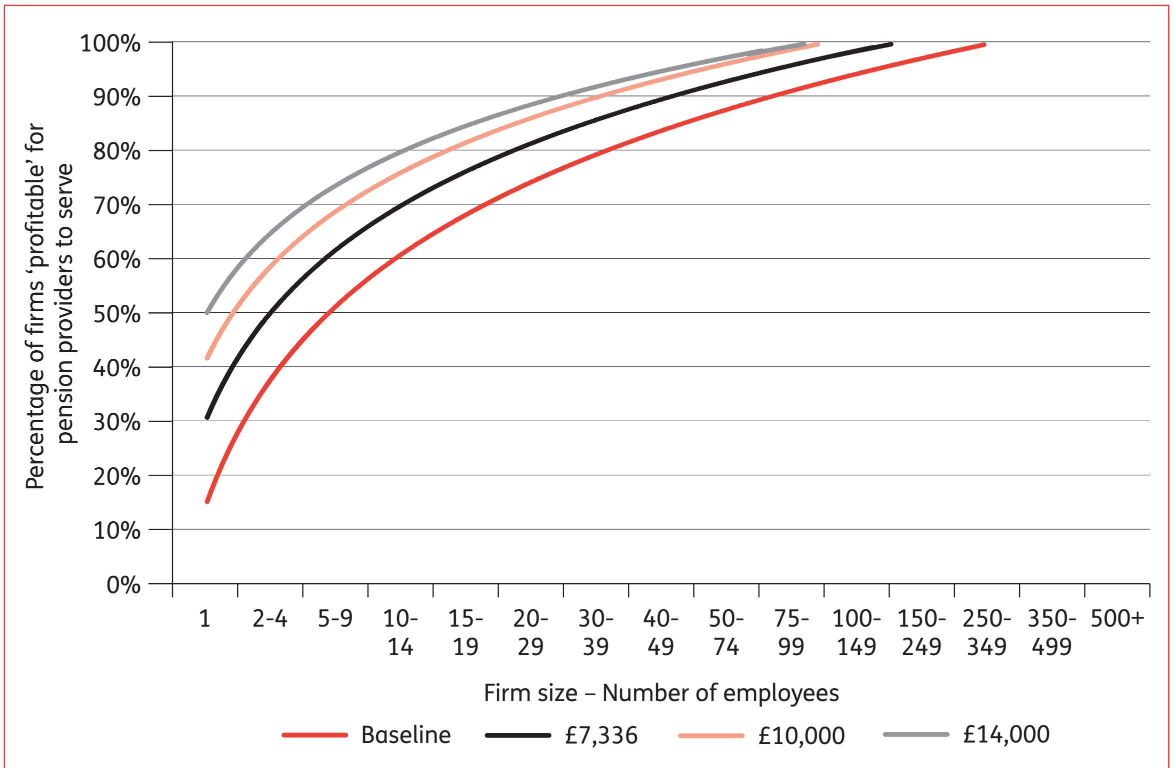


Source: Department for Work and Pensions modelling.

Profitability analysis under charges at the Stakeholder Charge Cap

Chart 7.2 shows the impact if charges move up to the Stakeholder Charge Cap. As we would expect, industry profitability increases, though the smallest employers remain unprofitable.

Chart 7.2: Profitability under different earnings thresholds, assuming charges at the Stakeholder Charge Cap



Source: Department for Work and Pensions modelling.

We can see from these charts that the assumed level of charges makes a significant difference to the ability of the pensions industry to serve the market. At the lower charge levels (Chart 7.1), only 35 per cent of firms with 10-14 employees would be profitable to serve, compared with around 60 per cent under the stakeholder charge cap (Chart 7.2). Nevertheless, even with an earnings threshold of £14,000 and charges at the Stakeholder Cap, only 50 per cent of single employee firms would be profitable for the pensions industry to serve.

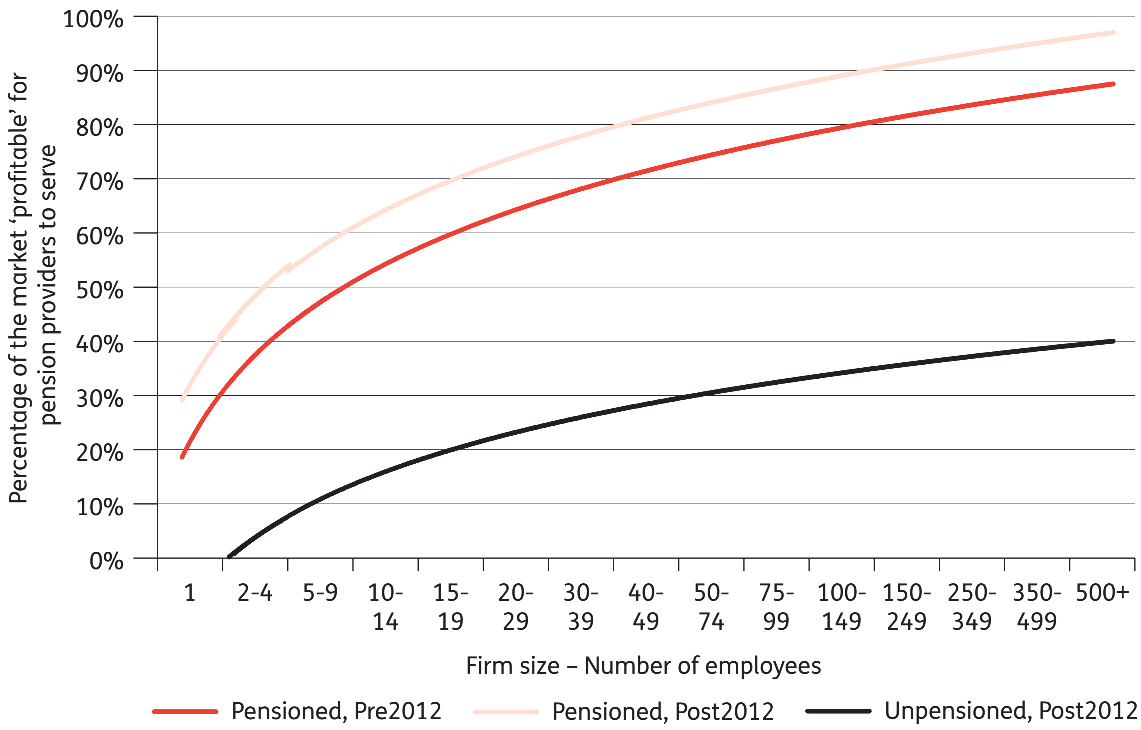
7.2.4 Contribution levels: exclude micro employers

Excluding micro employers increases the average contribution levels from those employers that do still fall under the duties. Chapter 4 explains the impacts of employer size on profitability, whilst the rationale and arguments for and against excluding micro employers are set out in Chapter 5.

Profitability analysis under charges of 3 per cent contribution charge plus 0.5 per cent AMC

We can see from Chart 7.3 that larger employers are significantly more likely to be profitable than smaller employers. Nevertheless, under low charges, even if firms with fewer than five employees were excluded, NEST would be necessary to service significant numbers of small firms, particularly those with no previous pension provision. We would assume that NEST may also provide for lower-paid and high-churn individuals who are currently unpensioned but work for firms with some form of existing provision. Overall, NEST might expect to provide for at least some employees working for around 90 per cent of firms with 5-9 employees, and even around 65 per cent of firms with 75-99 employees.

Chart 7.3: Profitability by employer size, assuming 3 per cent contribution charge plus 0.5 per cent AMC

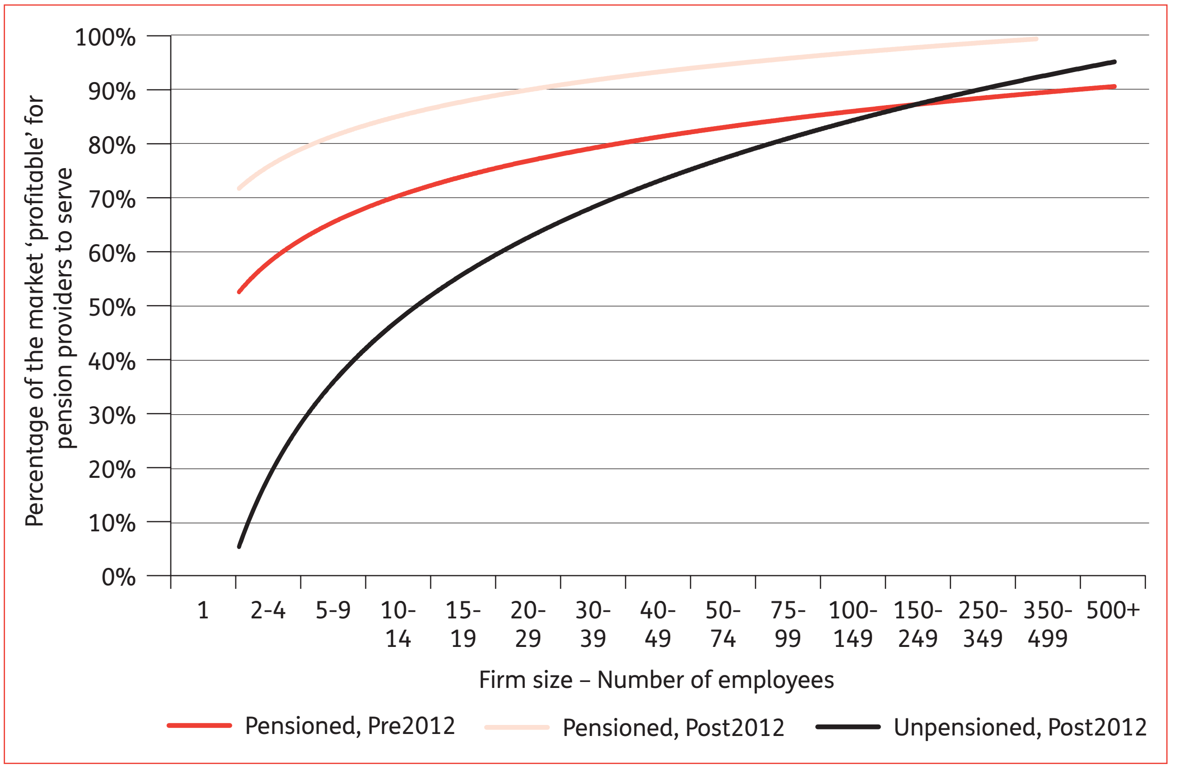


Source: Department for Work and Pensions modelling.

Profitability analysis under charges at the Stakeholder Charge Cap

Chart 7.4 shows how industry profitability could be expected to change if charges were at the current stakeholder level. Again, we see that profitability increases, but that a significant group of employers remain who are not expected to be profitable. Around 50 per cent of all previously unpensioned firms with 10-14 employees, and almost 60 per cent of firms with 5-9 employees, remain unprofitable for the pensions industry to serve. This suggests that a supply gap would persist even if micro employers were excluded and charges were allowed at the stakeholder limit.

Chart 7.4: Profitability by employer size, assuming charges at the Stakeholder Charge Cap

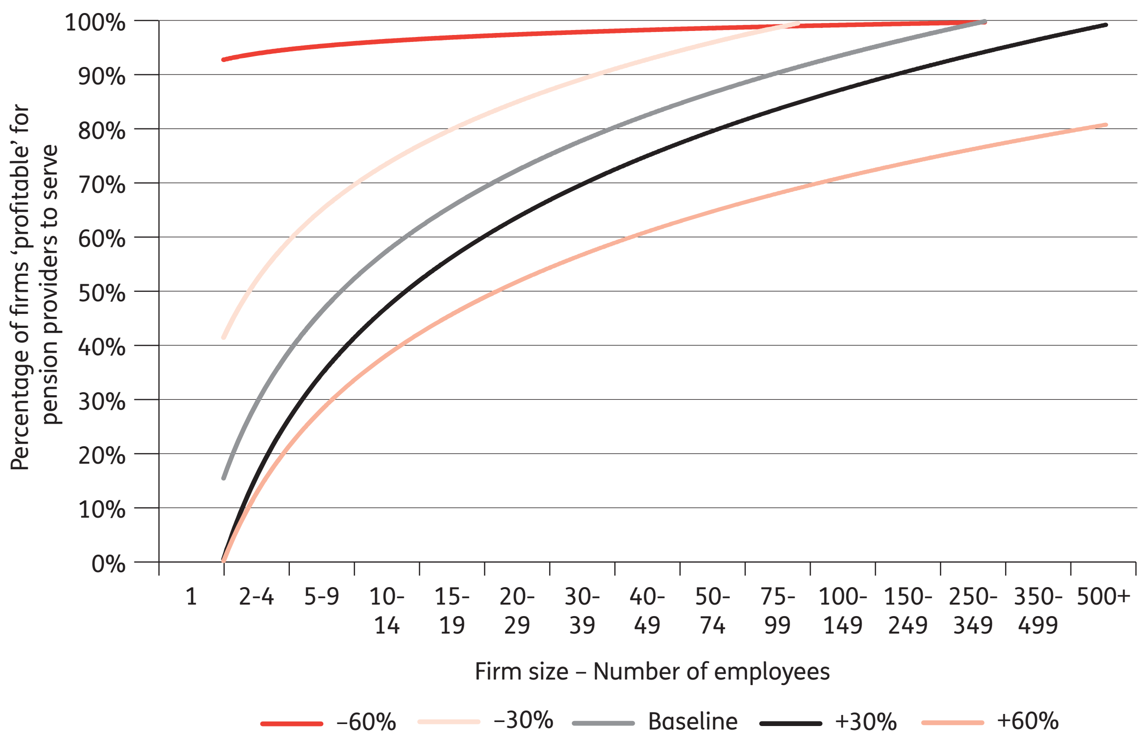


Source: Department for Work and Pensions modelling.

7.2.5 Reducing costs and improving persistency

Costs are essential to profitability and we have, therefore, considered a number of deregulatory changes that could reduce costs for providers. Whilst it is difficult to put exact numbers to these cost reductions, we can get a feel for how sensitive industry profitability is to costs. Chart 7.5 illustrates the changes in profitability across employer sizes if providers' costs were changed by thirty per cent, or by sixty per cent. The solid black line gives the baseline, using the average costs supplied by interviews with a range of industry representatives. From this we can see that if costs fell by 30 per cent, the proportion of employers with 2-4 employees that are profitable would increase from just less than 40 per cent to around sixty per cent. If costs rose by the same amount, profitability would drop by between ten and twenty per cent across all firms.

Chart 7.5: Profitability by size of employers where costs are changed by plus or minus 30 per cent and 60 per cent against the baseline (black)



Source: Department for Work and Pensions modelling.

One key way of reducing costs is to increase persistency: Chart C.3.2.3 in Annex C highlights just how important persistency of saving is in determining profitability within the pensions industry. Options such as making saving compulsory would have the greatest impact on persistency, but there are other options within Chapter 5 that would improve persistency.

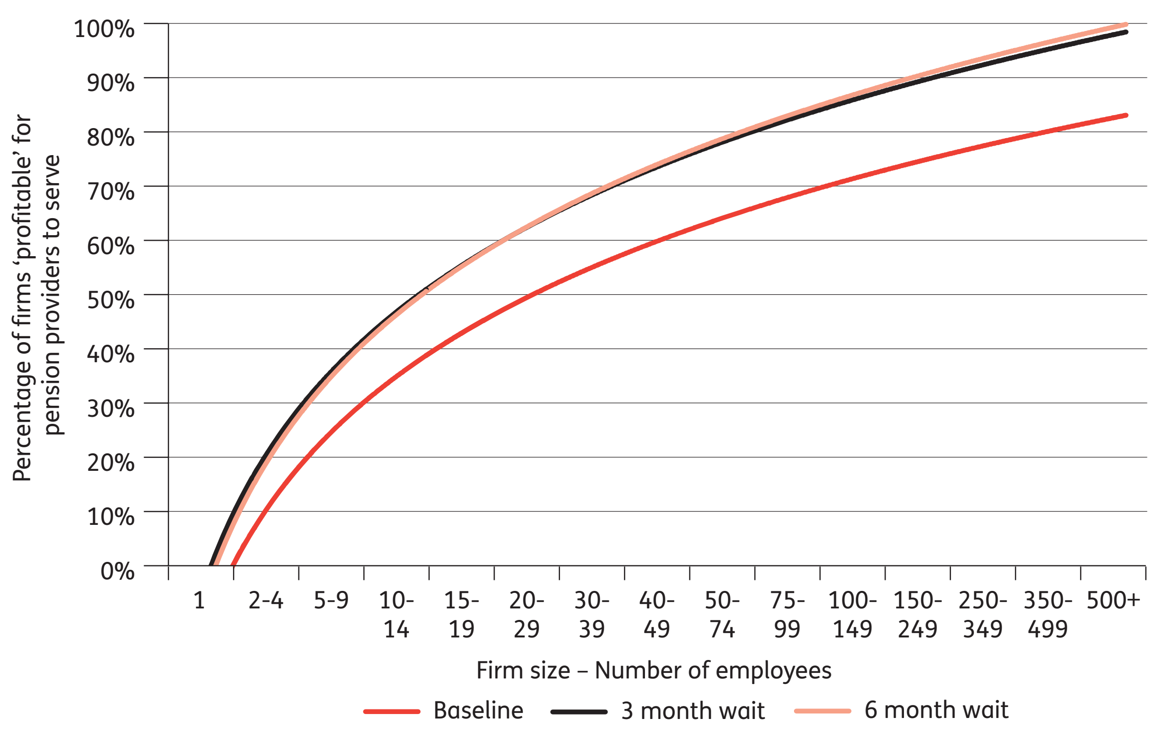
Under current policy, employers are required to automatically enrol eligible jobholders from day one of employment or when they become newly eligible. There are a group of people who move employment frequently and so will be repeatedly enrolled into pension saving for a short amount of time. Having a waiting period before automatic enrolment would remove these people from automatic enrolment and increase average persistency levels. Many industry representatives supported the idea of a waiting period, citing reductions in administrative burden and in the numbers of small pots as a key benefit.

Profitability analysis under charges of 3 per cent contribution charge plus 0.5 per cent AMC

Chart 7.6 analyses profitability for providers when a three month or six month waiting period is introduced. While waiting periods reduce the total amount that will be contributed to a fund over its life (because what would have been the contributions from the initial period of an employment spell are 'lost') they also 'filter out' employees who would leave an employer's pay shortly before joining it, and who would therefore only build a small pension pot (on which the provider accrues charge revenues).

The effect of a waiting period is very similar for the three month or six month option. For either option, the effect is to increase the proportion of profitable employers by around 10-20 percentage points. The increase in profitability is less pronounced for smaller employers. Alternatively, introducing a waiting period reduces the employer size needed to cross the '50 per cent profitability' threshold from 20-29 employees to 10-14, on our low-charge scenario.

Chart 7.6: Profitability with three and six month waiting periods, assuming 3 per cent contribution charge plus 0.5 per cent AMC

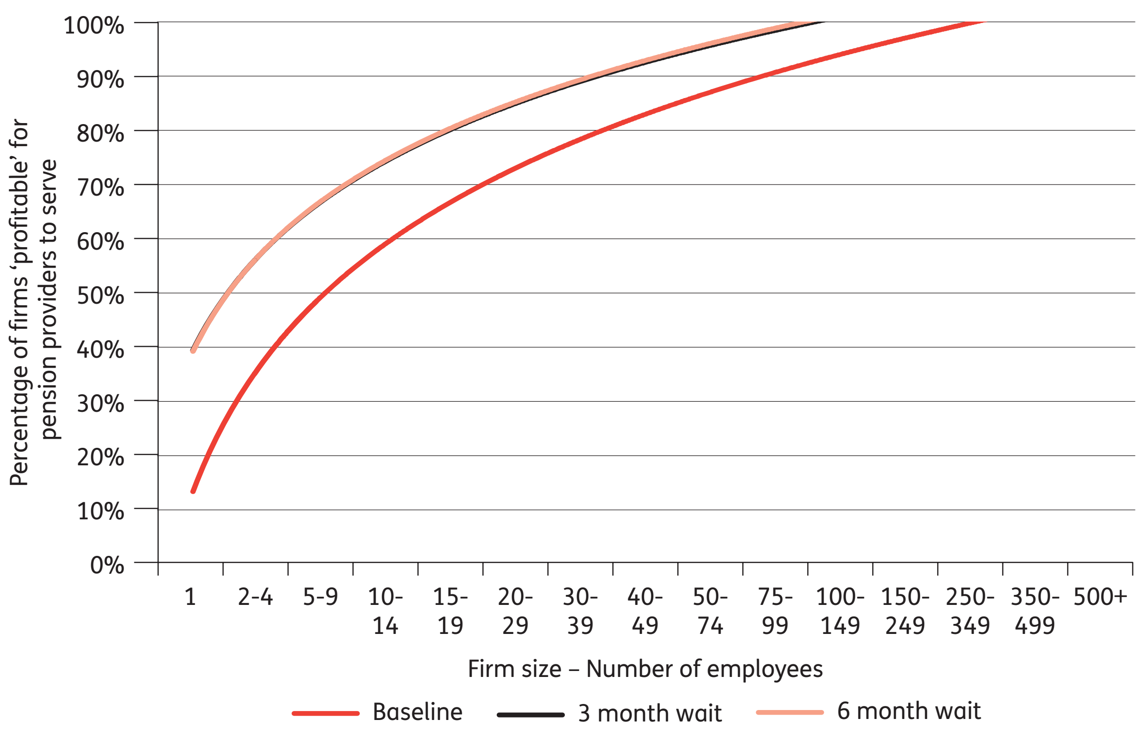


Source: Department for Work and Pensions modelling.

Profitability analysis under charges at the Stakeholder Charge Cap

Chart 7.7 replicates the above analysis under an assumption that charges are higher. As with the other examples, this increases profitability but leaves a significant group of employers who would be unprofitable, primarily micro employers.

Chart 7.7: Profitability with three and six month waiting periods, assuming charges at Stakeholder Charge Cap



Source: Department for Work and Pensions modelling.

7.3 Effects of combined options

Whilst the single options above may each have limited impacts on market profitability, combinations of these options may provide a more viable solution. The analysis below shows the impact on profitability of a range of combined options.

7.3.1 Excluding micro employers, plus waiting periods

Profitability analysis under charge levels of 3 per cent contribution charge plus 0.5 per cent AMC

From Chart 7.6 we can see that with a three month or six month waiting period and excluding either single-employee employers, or micro employers, the supply gap persists. Nearly half of employers with 15-19 employees are unprofitable even with a three or six month waiting period under these charge levels, indicating that there is still a need for NEST under this scenario.

Profitability analysis under charges at the Stakeholder Charge Cap

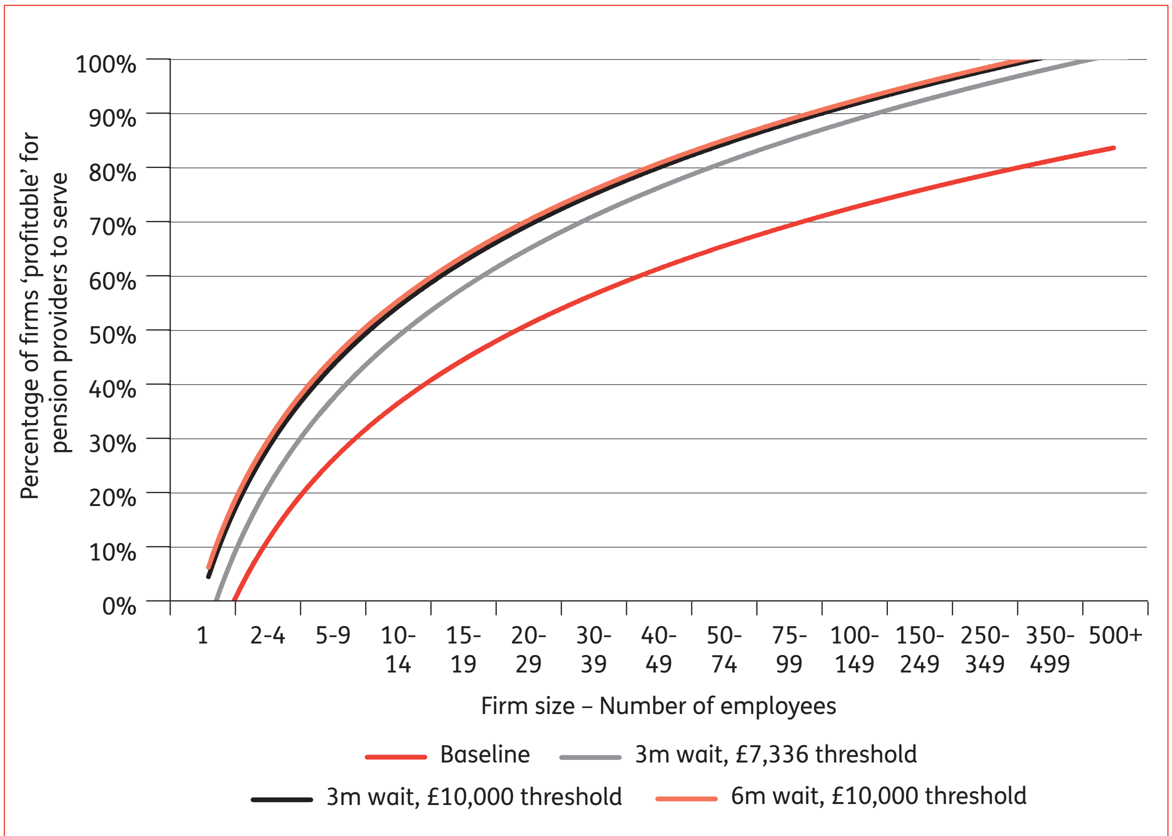
Under lower charge levels, there is clearly a need for NEST even if micro employers are excluded and a waiting period is introduced. If charges move up to the current Stakeholder Cap, Chart 7.7 illustrates that this position starts to look rather different. If only single-employee employers are excluded, then the supply gap does persist, since a significant number of firms with 2-4 employees are not profitable even with a waiting period. However, if all employers with fewer than five employees are excluded, then a purely industry solution begins to look more viable. 70 per cent of firms with five to nine employees and nine out of ten firms with upwards of 30 employees are profitable if a waiting period is introduced. However there is still a risk here that firms with five to nine employees will find it difficult to source pension provision.

Increasing earnings thresholds plus waiting periods

Profitability analysis under charge levels of three per cent contribution charge plus 0.5 per cent AMC

Chart 7.8 illustrates the impacts of combining a £10,000 earnings threshold with three month and six month waiting periods assuming that NEST is present, driving down charges in the market. Chart 7.9 illustrates the effect of increasing this earnings thresholds to £14,000, plus waiting periods. For both earnings thresholds, the precise length of the waiting period makes relatively little difference.

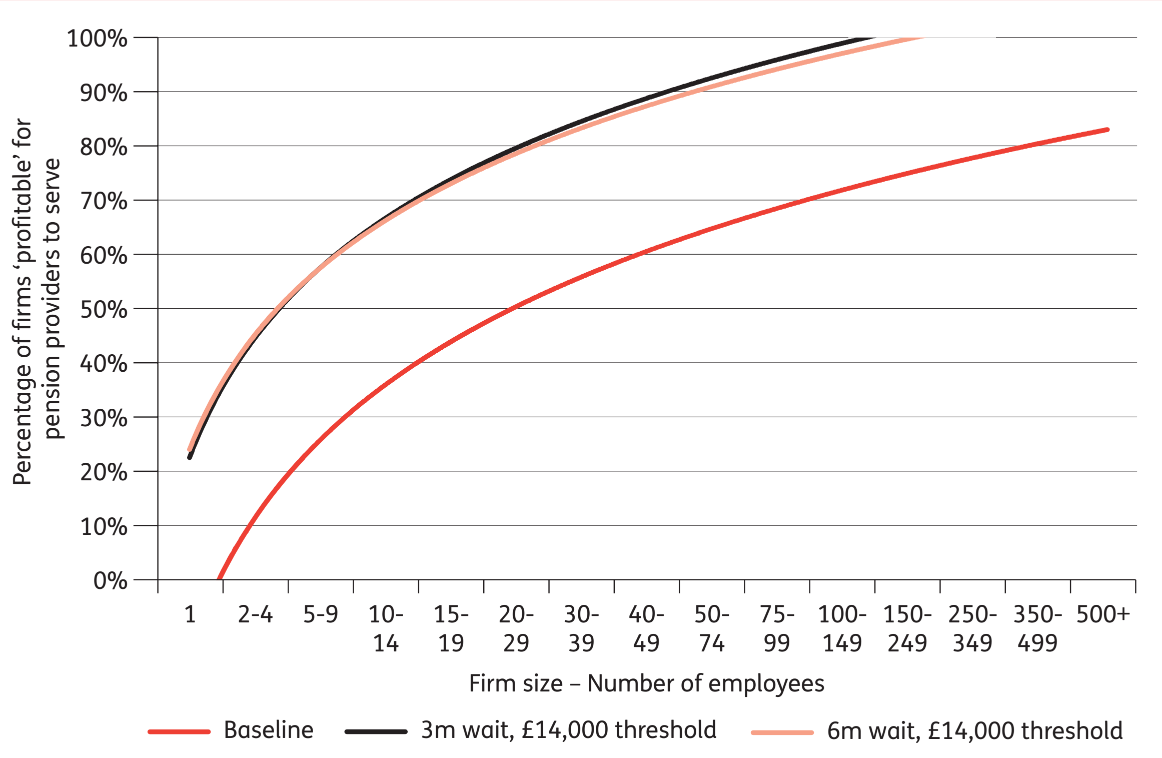
Chart 7.8: Profitability with £7,336 and £10,000 earnings thresholds and waiting periods, under a three per cent contribution charge and 0.5 per cent AMC



Source: Department for Work and Pensions modelling.

Under a £10,000 earnings threshold plus a waiting period, the employer size band at which at least 50 per cent of employers are unprofitable for the market to serve at NEST equivalent charges falls from 20-29 employees to 10 employees.

Chart 7.9: Profitability with £14,000 earnings threshold and waiting periods, under a 3 per cent contribution charge and 0.5 per cent AMC



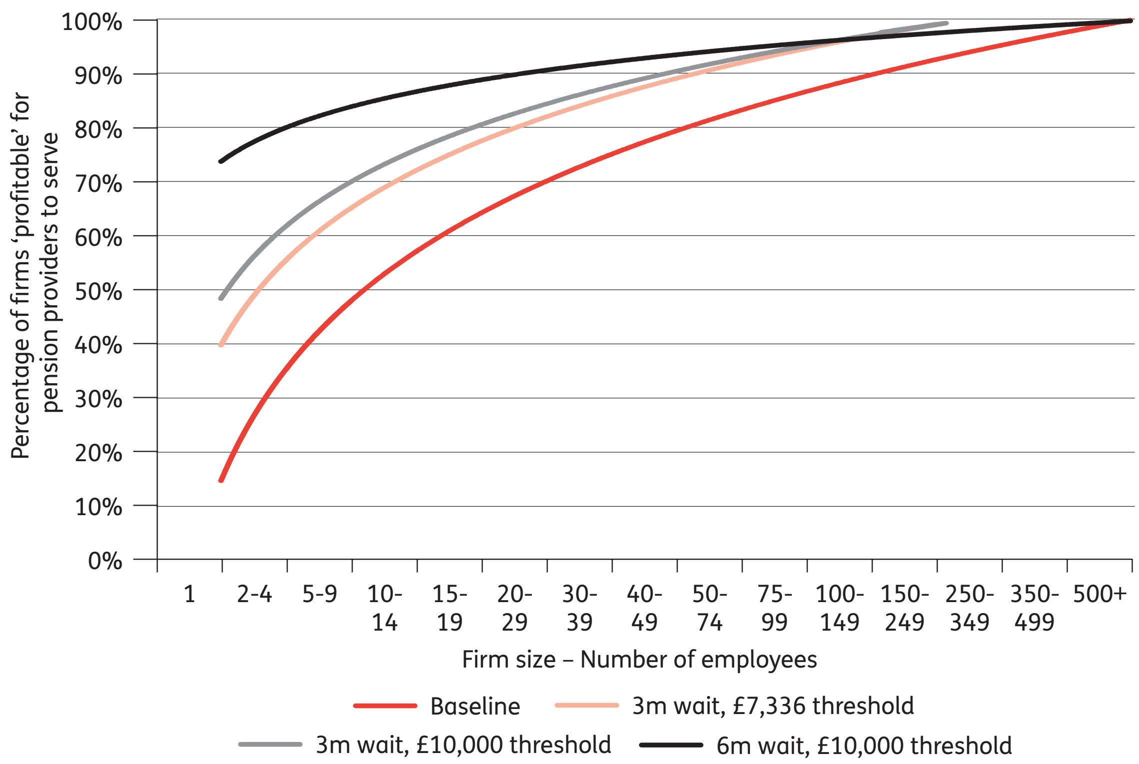
Source: Department for Work and Pensions modelling.

Under a £14,000 earnings threshold plus a waiting period, the employer size band at which at least 50 per cent of employers are profitable for the market to serve at charges of 0.5 per cent AMC plus three per cent contribution charge falls from 20-29 employees to five employees.

Profitability analysis under charges at the Stakeholder Charge Cap

Under charge levels of a 3 per cent contribution charge plus 0.5 per cent AMC, there is clearly still a need for NEST to service the smaller employers. Charts 7.10 and 7.11 illustrate these options if charges increase to Stakeholder Charge Cap levels.

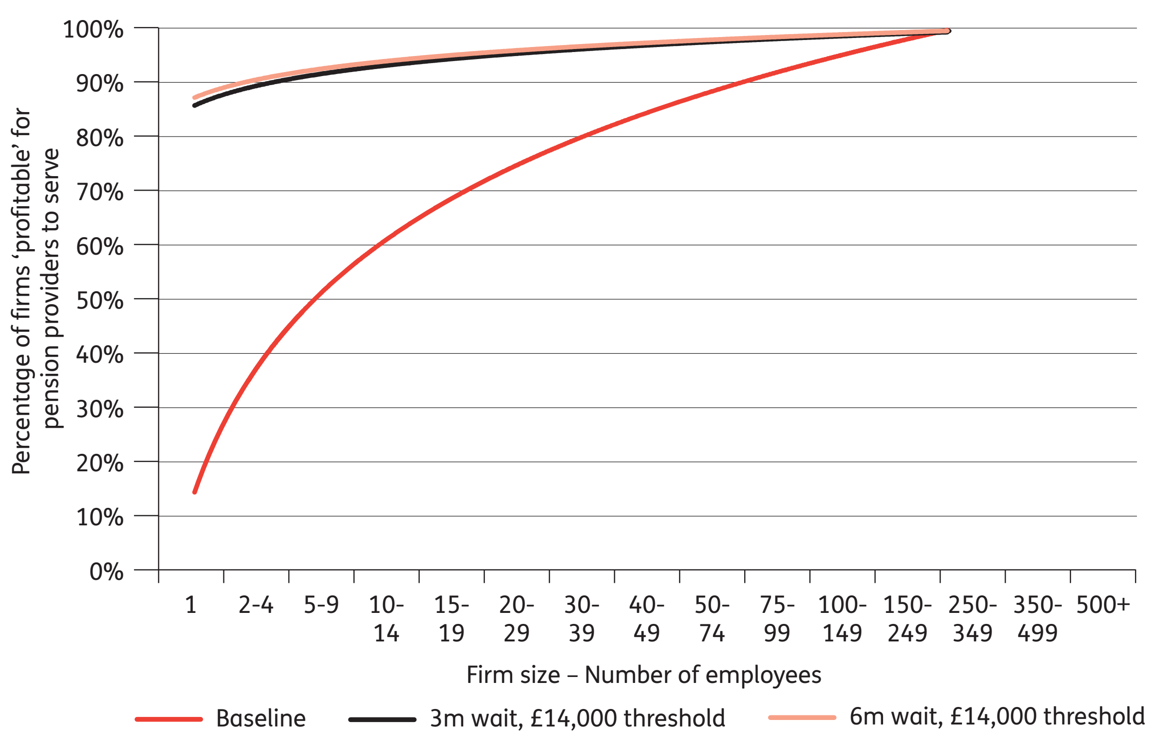
Chart 7.10: Profitability with £7,336 and £10,000 earnings thresholds and waiting periods, under charges at the Stakeholder Charge Cap



Source: Department for Work and Pensions modelling.

At a charge level of the Stakeholder Cap and under a £10,000 earnings threshold plus a three month waiting period, around two thirds of all employers with 2-4 employees are profitable for the market to serve, with around three quarters of all employers with 5-9 employees and all employers with 100 or more employees being profitable. However, only half of employers with one employee would be profitable to serve under this option.

Chart 7.11: Profitability with £14,000 earnings threshold and waiting periods, under charges at the Stakeholder Charge Cap



Source: Department for Work and Pensions modelling.

At a charge level of the Stakeholder Cap and under a £14,000 earnings threshold plus a waiting period, nearly all employers with two or more employees are profitable for the market to serve. Again, employers with only one employee are less profitable.

It seems reasonable to assume that under either of these scenarios the existing pensions industry may be able to serve the whole market under this charge cap, given this profitability analysis. However, there are other implications of these options especially in relation to individuals' savings, which are outlined in Chapter 8. It must also be remembered that charge levels do have a substantial impact on fund values over time. A median earner with a full savings history would lose 22 per cent of the value of their fund at the stakeholder charge cap, compared with only 12 per cent of their fund under an AMC of 0.5 per cent plus a contribution charge of 3 per cent (see Chapter 4).

7.3.2 Increasing earnings thresholds and excluding micro employers, plus waiting periods

Profitability analysis under charge levels of three per cent contribution charge plus 0.5 per cent AMC

From Chart 7.8 we can see that an earnings threshold of £10,000 plus a three month waiting period would still result in a supply gap under charges of three per cent contribution charge plus 0.5 per cent AMC, even if micro employers are excluded from the reforms, since 55 per cent employers with five to nine employees, and 45 per cent of employers with 10-14 employees are unprofitable under this scenario.

Similarly, with an earnings threshold of £14,000 plus a three month waiting period excluding micro employers would still leave a supply gap under these charges. Under this scenario, 40 per cent of employers with five-nine employees are not profitable.

Profitability analysis under charges at the Stakeholder Charge Cap

If we assume that charges increase to the Stakeholder Charge Cap, then a triple option of an increased earnings threshold, waiting period, and excluding micro employers, appears to allow the pensions industry to meet demand (see Charts 7.10 and 7.11). With a £10,000 threshold and three month waiting period, then one quarter of firms with five-nine employees would not be profitable, but given the increased profitability overall, it is possible that the pensions industry may be able to provide universal coverage at stakeholder charge levels.

Having found a theoretical option that would allow the pensions industry to meet the demand created under automatic enrolment, Section 7.2.4 looks at more extreme options which would provide more assurance to pension providers of their ability to meet demand. We revisit this question in Chapter 8, looking at a range of reform scenarios.

7.3.3 Exclude more employers or increase charge levels

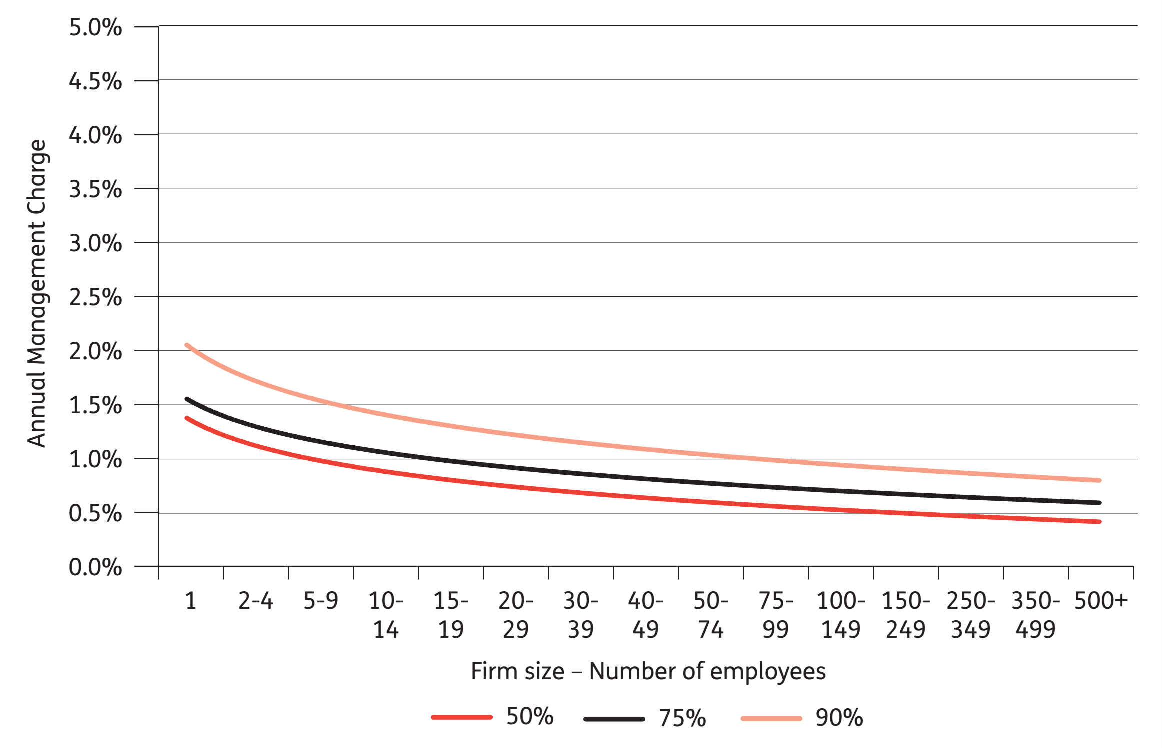
As we have seen, increasing the earnings threshold to £14,000, introducing a three month waiting period and allowing charge levels up to the Stakeholder Charge Cap gets us most of the way to making the whole of the employer market profitable for pension providers to serve. Excluding single-person employers then appears to eliminate the supply gap entirely.

However, if we want a solution with a lower earnings limit of £10,000 alongside the waiting period, then the key approaches are likely to be either to exclude more groups of employers, or to allow charges to exceed the Stakeholder Charge Cap. We can see that excluding employers with fewer than ten employees provides roughly 90 per cent profitability across the market.

Alternatively, Chart 7.12 shows that, in order to obtain 90 per cent profitability for all sizes of employer, charge levels would have to be at 2.0 per cent for the single person employers, 1.7 per cent for the firms with two-four employees, and below one per cent for those with 75 or more employees.

If the pensions industry felt able to provide universal coverage when at least 75 per cent of the market is profitable, then charges could be a maximum of 1.5 per cent.

Chart 7.12: Charge levels required to make half, three quarters, or 90 per cent of the market profitable where the earnings threshold is £10,000, and with a three month waiting period



Source: Department for Work and Pensions modelling.

7.4 Conclusions

The chapter considered whether changes to the target group for automatic enrolment and the way in which automatic enrolment happens would make pension provision more profitable and attractive to private pension providers, and in so doing enable all employers still covered by the automatic enrolment duties to find a commercial pension provider in the absence of NEST.

A triple option of an increased earnings threshold to between £10,000-15,000, a waiting period, and excluding smaller employers, would seem to allow the pensions industry to meet the demand.

However, we need to bear in mind the general caveats around the modelling. Whilst this gives us a good sense of the profitability, there are inevitably other considerations to take into account when thinking about whether the pensions industry would in fact serve a particular segment of the market. The modelling cannot take into account the nuances in variation across the pensions industry, and cannot factor in issues such as business model, risk averseness and so on. The modelling also takes no account of the right of individuals to opt in, either where their earnings fall between £5,035 and £10,000 or during a waiting period. If this practice were widespread it could undo the financial changes arising from these relaxations.

We note the steer from stakeholders that whilst changes in scope would certainly help towards an industry supply solution, there are always likely to be particular pockets of the market that they might not want to serve.

And there are, of course, other considerations to take into account when considering the correct scope for automatic enrolment, including the increases in overall pension saving achieved and the impact on individuals, both which individuals are brought into pension savings at all and the returns from savings for those that do save. These arguments are considered in the other Chapters, especially Chapter 5, and Chapter 8 brings together our overall conclusions.

Trade-offs and recommendations 8

Summary

In this chapter, we bring together all the analysis from earlier chapters to consider the most appropriate overall policy package to support the introduction of automatic enrolment.

First, we draw conclusions on the coverage for automatic enrolment that strikes the best balance for individuals; we consider the regulatory burden on the smallest employers and how this can best be mitigated; and we assess a range of further deregulatory measures.

We then bring these conclusions together and assess the impact of the overall package of change they represent, considering the impact against the assessment criteria set out in our terms of reference.

Finally, we compare this analysis with the impact of some alternative scenarios to demonstrate the trade-offs between different possible approaches.

This leads to our final package of recommendations:

- **The earnings threshold at which an individual is automatically enrolled into a workplace pension is increased and aligned with the income tax personal allowance and the threshold at which pension contributions become payable is aligned with the National Insurance primary threshold. Workers can opt in to saving and receive an employer contribution if they earn between these two thresholds.**
- **There should no changes to age thresholds.**
- **The automatic enrolment duties should apply to all employers regardless of size as now.**

- **Communications to micro employers from The Pensions Regulator should flag as strongly as possible that the design of NEST specifically takes account of their needs, and should support easy access to NEST.**
- **DWP should look to provide maximum possible comfort to employers that they will not be held liable for their scheme choice, particularly if they opt for NEST or a stakeholder scheme to fulfil their new duties.**
- **There should be a simpler system by which employers can certify that their defined contribution pension scheme meets the required contribution levels.**
- **There should be an optional "waiting period" of up to three months before an employee needs to be automatically enrolled into a workplace pension. Workers can, however, opt in during the waiting period.**
- **The largest employers, who are scheduled to be brought into the reforms in October and November 2012 should be allowed to automatically enrol ahead of the planned start date of October 2012, and as early as July 2012, if they wish to do so.**
- **Employers should be given flexibility around the date they re-enrol employees who have previously opted out by allowing a six month window for this activity to take place.**
- **NEST should go ahead as planned to support successful implementation of automatic enrolment.**
- **Legislation should make clear that NEST's "contribution cap" will be removed in 2017.**
- **Government and regulators should review as a matter of some urgency how to ensure that it is more straightforward for people to move their pension pot with them as they move employer, so that, by the time of the 2017 review, the more general issue of pension transfers has been addressed and NEST is able to receive transfers in and pay transfers out.**
- **Government should review as a matter of some urgency the scope for regulatory arbitrage between the trust and contract based regulatory environments.**
- **Government should continue with work to review whether the existing regulatory regime for the provision of defined contribution workplace pensions remains appropriate in the post automatic enrolment world.**
- **Government should ensure there are effective communications to individuals, employers (and especially smaller employers) and the pension industry in the lead up to and during the implementation of the reforms.**

We believe that these recommendations, taken together as a package, represent a fair balance between employees, employers (both small and large) and the taxpayer. They represent a realistic updating of the original Pensions Commission proposals in the light of the current economic position, while supporting the speedy implementation of these important reforms.

8.1 Introduction

Chapters 5, 6 and 7 work through the effects of a number of different options in detail. In this Chapter, we evaluate the key options against our objectives to build the most appropriate package of changes to achieve the aims of the review. We then look at different possible approaches and compare three core models against the status quo policy.

In undertaking this review we were asked to consider whether the proposed scope of automatic enrolment strikes the right balance between costs and benefits for individuals and employers and, in the light of this, whether NEST is the most effective means of delivering private pension reform. In recommending any changes to the current scope of automatic enrolment there are two core issues:

- For most people, pension saving will be beneficial. However, there are some low earners who would achieve little or no welfare benefit in "consumption smoothing" over their lifetime. We need to ensure that the scope of automatic enrolment correctly balances the risk of being over-inclusive against the risk of excluding some people for whom it would genuinely pay to save.
- Whether the burdens on employers and, particularly smaller employers, are proportionate and whether greater regulatory simplicity can be achieved without jeopardising the aims of the reforms.

In evaluating the best options for delivering improvements, there are inherent trade-offs between the benefits for individuals and burdens on employers. The core objective of the reforms has always been to get more people into saving and reduce pensioner poverty in the long term. It is important that we consider how far any set of options might start to erode this aim. In addition, key considerations are maintaining the consensus behind the reforms, operational implications of any change and the importance of meeting the current target date of October 2012 for implementation. Looking at the combined options, we need to find the right balance between deliverability, employer burdens and maximising savings, whilst bearing in mind the other key concerns we have been asked to consider.

8.2 Ensuring the 'right' individuals are automatically enrolled

Our key concern here is ensuring that the right balance of risk is achieved between automatically enrolling an individual into pension savings who may not benefit from saving (relying on them to opt out) and not automatically enrolling an individual who should be saving (relying on them to opt in). Chapters 2 and 5 set out the arguments in detail.

8.2.1 Earnings thresholds

In synthesising the evidence (set out in Chapter 5), we concluded that there are two broad options:

- To raise the annual earnings threshold to around £14,000, excluding persistent low earners (and all those working full-time on national minimum wage) who have most risk of achieving a high replacement ratio without saving, but also excluding many employees who may gain from saving, either due to their current circumstances (e.g. low earners in higher-income joint households) or due to later changes in their hours of work and/or earnings.
- To leave the earnings threshold relatively low (£5,000 - £8,000), ensuring that all those likely to gain from savings are automatically enrolled, with the risk that some people who are automatically enrolled and then remain in pension savings may not see an overall gain in terms of social welfare from consumption smoothing (albeit they do retain the right to opt out).

We have been deterred from recommending a threshold of £14,000 by the risk of excluding many people who would benefit from saving. Many low earners will go on to earn more throughout their lives and may still benefit from building up persistent pension savings. Many individuals with low earnings are part of wider households with higher total incomes. 69 per cent of the 2.9m people excluded would be women, who tend to fare less well in retirement than men. Large numbers of those who would be affected by such an exclusion also have a substantial incentive to save as pension contributions do not count in assessing eligibility for working tax credit.

In keeping the threshold relatively low, we feel that there are nevertheless benefits of increasing the threshold away from the current level and separating the eligibility threshold from the bottom of the contributions band. There are considerable benefits in aligning the eligibility threshold with the personal income tax allowance and the bottom of the contribution band to the equivalent of the National Insurance primary threshold. We would envisage that, under this arrangement, any individual who is automatically enrolled continues to pay contributions until their earnings drop below the level of the bottom of the contributions band (unless they opt out).

Pros

- Excludes the very lowest paid, who are not income tax payers.
- Separates the eligibility threshold from the contributions threshold and effectively creates a de minimus for contributions. We feel this is important for the credibility of the reforms, since it avoids situations whereby individuals are making very small pension contributions. For employers this reduces the administrative costs relative to the benefits for employees.
- Aligning the threshold with an existing level (for paying tax) improves simplicity for everyone, and reduces the regulatory burden on employers.
- This arrangement provides a buffer for individuals who would otherwise repeatedly move in and out of pensions saving because their earnings fluctuated slightly, reducing the administrative burden for employers and ensuring greater persistency of saving.

Cons

- Maintaining a relatively low threshold runs the risk of automatically enrolling individuals for whom it might not pay to save (see Chapters 2 and 5 for a detailed discussion).

We are reasonably content that the opt out process is sufficiently simple to mitigate the risk of very low earners ending up saving inappropriately.

Recommendation:
The annual earnings threshold be aligned with the threshold for paying tax, (£7,336 in 2010/11 terms). The lower limit for the band of contribution should be aligned with National Insurance Contribution thresholds. Our presumption is that the thresholds would remain aligned with the tax allowance and National Insurance primary threshold, unless future action by Government resulted in a fundamental change in their purpose or in the relationship between them. In particular, we consider aligning the threshold at which a jobholder is automatically enrolled with the income tax threshold to be consistent with the Government's stated aspiration to increase the tax thresholds to £10,000 in nominal terms over the course of this Parliament. Workers can opt in to saving and receive an employer contribution if they earn between the two thresholds.

8.2.2 Age thresholds

Some stakeholders have suggested that the lower age threshold for automatic enrolment should be reduced, either to encourage saving from a younger age, or to align with the age threshold for entitlement to the national minimum wage. We feel that the lower threshold is a balance between establishing patterns of saving earlier and avoiding automatically enrolling very young people with high labour market churn (e.g. those working in temporary jobs whilst in tertiary education). We feel that the current threshold at age 22 strikes the right balance between these aims.

We are more concerned about the upper age limit, which could see older workers saving for relatively little benefit, particularly in the early years of the regime whilst contributions are phased in. Chapters 2 and 5 provide a detailed analysis of replacement rates for individuals who start to save at different ages. There was some limited support among employer and industry stakeholders for reducing the age limit to 55 (from state pension age). We discussed the impacts of this option in detail in Chapter 5, and our primary arguments can be summarised as:

Pros

- Removes older employees who will have less time to build up savings and may lose out through interaction with means tested benefits.

Cons

- Many older savers will still benefit from saving, including those with existing savings, which will be topped up by automatic enrolment contributions, and those with no previous savings, who may be able to trivially commute their contributions at retirement.

- We cannot assume that older workers would necessarily retire at State Pension age; excluding older workers could also conflict with the Government's current extended working lives agenda.

On balance, we feel that even small savings are still likely to be worthwhile for older savers and the upper age limit should not be reduced. At the same time, we would not consider increasing the upper limit beyond the State Pension age. We feel that this strikes the right balance between ensuring people have access to pension saving during their normal working lives and avoiding automatically enrolling people for whom saving is no longer the right option.

Recommendation:
The age band for eligibility remains at age 22 to State Pension age

8.3 Options to reduce burdens on employers

We are concerned about the regulatory burden of the reforms on employers as a result of the proposed automatic enrolment process and the risk to the credibility of the reforms that this brings. Our concerns include:

- Concern that the impact of the requirement to automatically enrol employees from day one, together with no facility for an employee to opt out before being enrolled, might lead to unwieldy processes and an unnecessary and disproportionate regulatory burden. This could damage the credibility of the reforms.
- Concern that assessing minimum levels of pension contribution as a percentage of a band of total earnings above an earning threshold is different to the way many employers currently assess contributions (often a percentage of "basic pay" from the first pound earned). This could make it burdensome for employers to assess whether their scheme meets the minimum level of contributions required by the new duties.
- A lack of flexibility around the dates employers are required to automatically enrol or re-enrol their employees into pension saving.
- Difficulties for employers, particularly smaller employers, in determining a suitable scheme to fulfil their new duties.

As discussed in Chapter 3, we are particularly concerned about the impact of the administrative burden on smaller employers because:

- There is a potentially high burden on the smallest employers.
- While the vast majority of employers are small employers, they employ a relatively small proportion of total employees. This raises the question of whether the regulatory burden, in conjunction with the costs of ensuring compliance, is proportionate to the benefits generated.

In Chapters 5 and 6 we have therefore explored a range of ways of reducing administrative burdens on business and smaller employers in particular. Here we summarise our key arguments and recommendations for each option.

8.3.1 Excluding micro employers

We have looked at the rationale and impacts of excluding different sizes of employers from the scope of the reforms, considering the cost savings to employers against lost benefits to employees.

Pros

- The smallest employers face a potentially high regulatory burden as a result of the reforms. Very few have any experience of administering pensions and most will not have dedicated HR functions to help with this. Removing micro employers from scope lifts this burden from them.
- We consider that micro employers present the highest risk to the compliance regime; removing these employers from scope would greatly reduce this risk.
- The cost of the regulatory regime would also be much reduced by excluding micro employers.
- The smallest employers employ a relatively small proportion of the workforce and therefore the administration costs generate proportionately less overall pension contributions.
- Many of those employing a single person are individuals employing carers and nannies. These individuals may be poorly placed to take on new costs and burdens.

Cons

- 1.5 million people would be excluded from automatic enrolment on a basis not related to the value to themselves of pension saving.
- There are practical concerns about the operation of an employer size cut-off, particularly in identifying at the margin which employers fall each side of the cut-off, and in how to treat employers who increase or decrease their workforce. For example, if an employer shrunk to below the threshold, a situation could arise whereby comparable employees within a single firm would have different pension rights based on when they joined the firm.
- There could be a strong disincentive against business growth; since the marginal contribution costs of hiring a fifth employee would quadruple if micro employers are excluded from automatic enrolment.
- Including all employers ensures a competitive level playing field, a point which some stakeholders have stressed.
- There would be a significant gender disparity among those affected, 71 per cent of the excluded group would be men.

On balance, we are persuaded that smaller employers should remain within the scope of the automatic enrolment duties. Nevertheless, we remain concerned about the burdens on small employers and are only content to recommend they remain within scope if other deregulatory options are implemented to ease their administrative burden.

It should be as straightforward as possible for small and micro employers to select an appropriate scheme, without a significant burden of choice. Consequently, we have looked at how to make it as easy as possible for micro employers to access NEST, given that the majority of micro employers are likely to use NEST.

8.3.2 Making NEST easily accessible for micro employers

There is a strong case for ensuring that micro employers can avoid the costs and potential confusion associated with looking for a scheme on the open market. Some of the smallest employers may be unable to find a provider able to offer them a suitable scheme at an appropriate charge level, so the choice for many could be effectively limited to NEST.

Whilst we do not think it appropriate that micro employers are simply defaulted into NEST, we consider that a sensible and effective approach would be for correspondence to micro employers from The Pensions Regulator to make clear that the design of NEST specifically takes account of their needs, and should support easy access to NEST.

NEST is specifically designed to meet the needs of smaller employers; that the scheme has a public service obligation to serve all employers who want to use it at a fixed charge level; and to provide contact details so that employers can access NEST easily. We recommend that Government should go as far as it can in making it clear to micro employers that NEST is an easy and appropriate choice for them.

8.3.3 Providing a 'safe harbour' for employers

Employers, and particularly smaller employers, have expressed concern that they might be held liable for the consequence of their scheme choice should the selected scheme turn out to perform badly.

We understand that the risk of an employer being found liable for automatically enrolling an employee into a scheme which underperforms is low and that the risk of employer liability for the provision of information to individuals is minimal. However, the issue for employers is not just the level of legal risk, but uncertainty about their potential legal liabilities.

We recommend, therefore, that government explores whether there are ways of providing legal assurances to employers when choosing a scheme to meet their automatic enrolment duties.

Recommendations:

- All employers remain within scope for automatic enrolment.
- NEST is strongly flagged to micro employers by The Pensions Regulator.
- DWP should look to provide maximum possible comfort to employers that they will not be held liable for their scheme choice, particularly if they opt for NEST or a stakeholder scheme to fulfil their new duties.

8.4 Further deregulatory options for reducing burdens on employers

In addition to looking specifically at regulatory easements for smaller employers, we have looked at a range of options to increase simplicity for all employers (Chapter 6), including a discussion of a universal waiting period (see Chapter 5 for detail). We take each of these options in turn and summarise the key issues for each, along with our recommendations.

8.4.1 Waiting periods

There is a range of arguments for proposing a waiting period as a way of reducing regulatory burdens:

- Removing high churn workers who represent a high administrative cost to employers for relatively small contribution gains.
- Allowing employers more time to complete all the processes involved in automatic enrolment.
- Allowing employees more time to decide whether they want to stay in the scheme or not, especially those on weekly pay.

Stakeholders have also linked a waiting period to the option of allowing employees to opt out before they are put into a pension scheme, citing this as a further way to reduce administrative burden. We have considered this option separately in Chapter 6. However, on balance we are not minded to recommend this option.

If we want a waiting period primarily to remove the burden of processing high-churn employees, this would lead us to a reasonably long waiting period. By contrast, if we are simply looking for an administrative easement to allow employers more time to complete automatic enrolment processes, then allowing an extra month or so flexibility may be sufficient. We feel that all of these reasons are important, and therefore examined a waiting period of up to three months. We feel that the most crucial points to consider are:

Pros

- A waiting period prevents employers from having to enrol and then un-enrol temporary workers. We feel that this nugatory work could otherwise undermine the credibility of the reforms. Out of around two million enrolments per year in steady state, 190,000 enrolments are for employees who leave within three months.[84]
- Allowing employers the flexibility to select an automatic enrolment date any time within a three month period enables them to align this activity with their existing payroll cycles.
- It also reduces the likelihood of the employee failing to return the opt out form before contributions are deducted, reducing the risk that refunds will have to be paid.
- A waiting period may mitigate the risk of employers choosing to use trust-based schemes to make use of rules for short-service refunds, which would result in poorer outcomes for savers.

84 Source: Labour Force Survey 2007. Figures based on people in the target group who had started a job within the previous 12 months.

- Employer and industry representatives have universally called for a waiting period as a means of easing regulatory burden.

Cons

- Consumer and employee representatives are against a waiting period as it risks excluding high churn workers from pension saving.
- On any particular day, 400,000 individuals would not be eligible for automatic enrolment due to the waiting period. Some employees may never access pension saving, if they work on short term contracts for the majority of their career. Even for those who are eventually enrolled, the average saver could lose up to three years worth of pension contributions over their lifetime.
- Replacing the easement only for "good quality" schemes with a universal waiting period, risks undermining the current benchmark for a "good scheme", with an associated risk of levelling down of existing provision.

On balance we feel that a waiting period strikes a reasonable balance between regulatory easement, particularly for smaller employers, and the risks to individuals' savings. However, in recognition of the impact on some individuals, we recommend that eligible employees be allowed to opt in to the scheme during the waiting period.

We discussed whether to couple a universal waiting period with a longer postponement option for higher quality schemes to give employers with such schemes an additional easement. This may help to maintain a higher benchmark for defining good quality schemes.

Overall, however, we concluded that the universal three month waiting period is sufficient to resolve the issues of employer churn.

Recommendation:
Employers be allowed to use a waiting period of up to three months before automatic enrolment; individuals are allowed to opt in to the scheme during that time. This replaces the existing postponement arrangement for employers using higher quality schemes.

8.4.2 Providing flexibility around when employers have to act

Stakeholders have called for greater flexibility around the timing of staging and re-enrolment. We have explored a number of ways of providing further flexibility, summarised below. Chapter 6 gives greater detail of the rationale and impacts of each option.

Flexibility around staging

We looked at whether it would be possible to give employers total flexibility around their staging date to align activities with their business cycles. However, we are convinced that this would not be operationally viable, since it could result in large numbers of employers selecting September 2016 as their staging date, substantially exceeding operational capacity and risking unstable implementation of the reforms. This could also result in members missing out on up to four years of contributions. We are therefore not recommending this option.

We then looked at allowing employers to select any day within a month as their staging date, allowing them to align this date with their existing payroll and thus avoid part-period calculations of contributions. Other things being equal, we were minded to recommend this option, but our recommendation of a waiting period of up to three months already allows this flexibility.

Stakeholders representing the interests of employment agencies suggested that all such agencies be staged in as a single group to mitigate competition effects. We have not seen convincing evidence that the competition problems are significantly greater for employment agencies than for other labour intensive businesses, but, more importantly, we do not think this would be operationally possible primarily because these employers are not readily identifiable but also because it would mean staging 1.3 million individuals on a single day. We are therefore not recommending this option.

Most employers will have the flexibility to bring their staging date forward if they wish to do so. There is, however, currently no facility to automatically enrol before the October 2012 start date for the reforms, which means the largest employers (with 50,000 or more employees) who are due to be brought into the reforms on 1 October 2012 and 1 November 2012 have no or only very limited flexibility around their staging date. We recommend that these employers be allowed to automatically enrol as early as 1 July 2012 if they wish to do so.

Flexibility around re-enrolment

We also looked at whether to remove or delay the re-enrolment requirement. We are convinced that re-enrolment serves as a useful trigger to prompt employees to reconsider their savings arrangements. Further, re-enrolment is helpful in preventing the 'erosion of compliance' that may occur once the staging date has passed, reminding employers of their continued duties. We feel that extending re-enrolment to five year cycles would potentially weaken the compliance regime and result in individuals missing out on saving. For these reasons, we are not recommending the removal or delay of re-enrolment.

We have, however, looked at providing employers with greater flexibility around the timing of re-enrolment and concluded that it is appropriate to allow a window of three months before and after the scheduled re-enrolment date to enable the employer greater freedom to select a time of year that suits their business.

Recommendations:

- Large employers due to be staged in October and November 2012 are able to choose to act early, up to July 2012.
- Employers have three months flexibility either side of their scheduled re-enrolment date.

8.4.3 Simplifying processes for employers

As set out in Chapter 3, automatic enrolment will require employers to undertake a series of tasks to comply with the duties, some of which will be new to them. We have therefore looked carefully in Chapter 6 at ways of simplifying these processes, to ease the administrative burden for employers.

Allowing individuals to opt out before automatic enrolment

Stakeholders have argued that not allowing opt out before automatic enrolment requires both the employer and employee to go through a process that could have been avoided in situations where the employee already knows they do not want to save. This will result in the employer taking contributions which then have to be refunded and therefore creates nugatory work for the employer.

We therefore considered whether to allow employees to opt out during the waiting period (or in the run up to re-enrolment). We are attracted to this option as a deregulatory improvement, but there are a number of downsides to consider. It would represent a move away from automatic enrolment and the behavioural economic benefits of requiring an individual to become a member of a scheme before they can opt out. We have also been advised by DWP officials that it would require a significant re-working of the Pensions Act 2008, which is based entirely on the premise that enrolment comes before opt out. This rewrite of the Act would mean employers, the pensions industry and payroll providers would not have sufficient clarity to prepare for the reforms in time for the October 2012 implementation. On balance, we feel that the various problems with this option outweigh the deregulatory benefits and we therefore do not recommend this option.

Simplifying the opt out process

We have also looked at whether it would be possible to simplify processes for individuals to ensure that those for whom it is not appropriate to save find it easy to opt out. For example, we might broaden the source of the opt out form, simplify its contents and make it explicitly available from day one. However, we must balance simplicity against the potential risks associated with these changes, such as greater risk of coercion by employers, or the risk that individuals may sign the form immediately if it is available more easily, without really considering their options.

We feel that the existing opt out processes are sufficiently simple that any further gains would be marginal and outweighed by the risks associated with the posited changes. We are therefore not recommending any change.

Calculating contributions on basic pay from £1

The definition of 'qualifying earnings' differs from the pay definitions that most employers use to calculate pension contributions. We have considered whether to change the definition of qualifying earnings to a simpler one using basic pay calculated from pound one. However, we are persuaded that the additional employer and exchequer costs are likely to make this option untenable. Further, we consider, and stakeholders largely agree, that a simple "certification model" (see below) would address concerns about the qualifying earnings definition. We are therefore not recommending this change.

Simplifying certification of eligible schemes

We have considered how to help those employers with existing good defined contribution schemes to determine that their scheme meets the qualifying criteria in the Pensions Act through a self certification model. It is critical to get this model right and make it as simple as possible. Without this easement, automatic enrolment poses real challenges for employers who have existing good schemes, but who calculate pension contributions on a definition of pay different from qualifying earnings. We do not want to see these employers discontinue their good pension provision, or level down contributions, to cover the costs of administrative changes associated with calculating qualifying earnings.

DWP has been working closely with employers and the pensions industry to design a self certification model that delivers flexibility for employers without diluting the qualifying criteria in the Pensions Act. As part of those discussions, a light-touch, three-step approach has been developed:

- A scheme can be certified as suitable if it requires, at a minimum, a nine per cent contribution of basic pay (including a four per cent employer contribution); or
- It can be certified as suitable if it requires, at a minimum, an eight per cent contribution of basic pay (with a three per cent employer contribution) provided pensionable pay constitutes at least 85 per cent of the total pay bill; or
- It can be certified as suitable if it requires, at a minimum, a seven per cent contribution of basic pay (three per cent employer contribution), provided that the total pay bill is pensionable.

We have concluded that a certification model along these lines strikes the right balance between regulatory burden and protection for individuals.

Recommendation:
That Government implement this simple certification process.

8.4.4 Other deregulatory options

Removing the NEST contribution cap

In Chapter 6, we discuss in detail the rationale and impacts of removing the NEST contribution cap. There are potential benefits to removing the cap, in terms of providing greater flexibility to employers and employees and reducing administration costs for employers and NEST in monitoring contribution levels. We are also concerned that the contribution limit in NEST sends an unhelpful message about 'appropriate' levels of saving. However, these issues are balanced against the likely competition impact of removing the cap. The pensions industry would be opposed to a lifting of the cap, as they see this as one of the primary levers in ensuring that NEST remains focussed on its purpose of meeting the 'supply gap' for low to moderate earners and smaller employers.

We have concluded that the cap is probably appropriate whilst NEST is being established and employers are making their initial choices about pension provision. However, once the reforms are bedded in, we feel very strongly that the cap should be removed to facilitate greater flexibility for savers. We are therefore recommending that the Government legislate for the removal of the contributions cap in 2017.

Removing the NEST transfer restrictions

The prohibition of transfers in and out of NEST, other than in limited and specific circumstances is intended to target the scheme on the supply gap which exists at the lower end of the market, and ensure that it complements, rather than competes with the existing pensions market.

However, facilitating transfers is, in our opinion, critical to the longer term success of the reforms. In a world where automatic enrolment makes pension saving the norm, including for low earners and people who move jobs frequently, there is a much higher risk that an individual's pension savings become fragmented in a number of small pots. Our view is that, as pension saving in defined contribution schemes becomes much more widespread, so should moving and consolidating pensions saving when changing employer.

This is, however, an issue that goes beyond how transfer rules are applied to NEST. In the market more generally, transfers are restricted by frictional costs, including the cost of regulation and advice. Our conclusion is, therefore, that there needs to be more wholesale consideration of how transfers can be facilitated much more easily across the pensions market as well as in and out of NEST. We recommend that Government undertakes a further review, in advance of the 2017 review of the restriction on transfers for NEST, to consider how transfers across the pensions industry can be made easier, so that individuals are better able to consolidate their pension savings as they change employment over their working life. This work should ensure that, once the automatic enrolment duties are staged in, we can move quickly to a world where transfers between pension schemes on change of employment, including transfers in and out of NEST, become a more normal practice.

Recommendations:

- The Government legislate for the contribution cap in NEST be removed in 2017.
- Government and regulators should review as a matter of some urgency how to ensure that it is more straightforward for people to move their pension pot with them as they move employer, so that, by the time of the 2017 review, the more general issue of pension transfers has been addressed and NEST is able to receive transfers in and pay transfers out.

8.5 Impacts of the package of recommendations

Full recommendations for immediate change:

- Eligibility threshold increased to £7,336 a year, in line with the threshold for paying tax; bottom of the contributions band to be aligned with National Insurance primary threshold with voluntary opt in between these thresholds.
- Universal waiting period of up to three months, with voluntary opt in during this period.
- Large employers due to be staged in October and November 2012 are able to choose to act early from July 2012.
- Greater flexibility around the timing of re-enrolment.
- Simplified certification process.

Compared with current policy, our package of recommendations has modest implications for the scope and impacts of automatic enrolment:

- One million fewer people eligible for automatic enrolment (-10 per cent against the baseline), with a reduction in total individuals contributions of £180m (-4 per cent).
- An increase in private pension income in 2050 against a non-reform scenario of £15.3bn (in 2010/11 prices); this is slightly lower than under the status quo policy (£16.3bn).
- A reduction in the eligibility for Pension Credit in 2050 of 175,000 households, compared with a non-reform world; this is lower than under the status quo policy (250,000 fewer households on Pension Credit).
- A six per cent increase in spend on Housing and Council Tax Benefits against the status quo policy.
- A reduction in “social welfare benefits” (the benefit in well-being terms of consumption smoothing) of around ten per cent.
- A marginal reduction in employer costs: year one administration savings of £10m (-2 per cent) and £6m (-4 per cent) in ongoing annual administration; employer contribution savings of £140m (-4 per cent).
- A marginal reduction in the amount of tax revenue forgone (as tax relief on pension contributions), by £90m in steady state (-4 per cent).

From this we can see that reductions in eligibility for automatic enrolment against the status quo policy feed through into lower pension contributions and thus higher eligibility for Pension Credit, Housing Benefit and Council Tax Benefit. However, this is balanced against lower costs for employers and also reduced costs for the Exchequer in terms of tax revenue forgone as tax relief on pension savings.

Looking at the profitability analysis in Chapter 7, it is clear that NEST is a necessary part of the reforms under this refined scope. Whilst the changes we are recommending will increase profitability in the market slightly (by eliminating the lowest earners and highest churn employees), a significant proportion of employers would still find it difficult to access pension provision without NEST, unless charges exceed the current stakeholder cap.

The changes we propose will require amendments to primary legislation, followed by additional secondary legislation. We would recommend that these changes be announced as soon as possible, to ensure that employers and payroll providers have enough time to prepare for implementation in October 2012. Analysis from The Pensions Regulator and NEST indicates that these changes would not present significant operational risks.

8.6 Alternative models for delivering pension reform

Overall, we feel that the scope of automatic enrolment is broadly right, and we have therefore recommended only minor changes to scope, with some additional deregulatory measures to ease burdens for employers. This conclusion is based on the premise that we should maximise pension saving as far as possible, and that sweeping reform affecting millions is the way to do this.

However, there are other rational models with more limited potential to deliver a step-change in pension saving. We then consider what the impacts of two different models might be, against the baseline for reform and against our package of recommendations:

- Alternative scenario 1: Eligibility threshold of £14,000, with a three month waiting period and excluding micro employers (with 1-4 employees).
- Alternative scenario 2: Eligibility threshold of £14,000, with a three month waiting period and excluding employers with 1-19 employees, without NEST.

Tables 8.1 and 8.2 set out all the impacts of these models in terms of individuals' savings, employer costs, Exchequer costs and programme costs. We also discuss the potential impacts for NEST of alternative scenario one.

Understanding the impacts for NEST

NEST is designed to be self-financing in the long run through member charges. In the short term there is a funding gap between set up costs incurred and charge revenues, which is being met by a loan from Government. The funding gap depends on the profile of costs and revenues, and this depends (as for all pension schemes) on the numbers and size of employer participating, the behaviour of members and contribution levels. The key parameters for illustrating the funding gap are the "peak funding requirement" (the outstanding balance at the point the revenues start to exceed the costs) and the repayment term of the loan, after which the scheme will have achieved self-funding status.

In terms of the impacts on NEST volumes, the various options will directly exclude some individuals, but will also change the numbers of employers who have no choice but to use NEST, because the pensions industry finds it so unprofitable to serve them. There may also be second-order impacts arising from changes in the policy environment, in terms of employer decisions over which scheme to use.

Table 8.1: Individual and employer impacts

	Eligible goup million	Total participation post reform million	Proportion of excluded group that are women percentage	Increase in private pension incomes £m	Numbers qualifying for pension credit	Spend on housing & council tax benefit £m	Social welfare benefits £bn	Year 1 employer admin costs £m	Steady state annual admin costs £m	Additional contribution costs £m	Employee total conts £m
Status quo policy	10-11	10-14	N/A	16,300	-250,000	-570	40 - 55	444	127	3,240	4,240
Review recommendations	-1.0	-1.0	59	15,300	-175,000	-410	35 - 50	434	121	3,100	4,060
Scenario 1	-4.0	-3.5	44	10,800	-109,000	-270	20 - 30	270	58	2,570	3,360
Scenario 2	-5.4	-4.8	46	6,300	-57,000	-210	15 - 25	158	31	2,010	2,630

Estimates of increases in private pension income in 2050, at 2010/11 prices; these figures represent the central scenario.
Annual figures for Pension Credit entitlement compared with a world with no private pension reform.
Social Welfare estimates for the period up to 2050; figures compared against a world with no private pension reform.

Source: Department for Work and Pensions modelling.

Table 8.2: Impacts on Exchequer and programme costs

	Tax relief £m	Exchequer cost £m	NEST volumes million	Repayment date	Peak funding £bn
Status quo policy	1,200	2,010	2 - 6	A couple of decades	0.5 - 1
Review recommendations	1,150	1,920	2 - 5	Around a one year increase on status quo	Negligible change
Scenario 1	940	1,570	See text	See text	See text
Scenario 2	720	1,220	N/A	N/A	N/A

Source: Department for Work and Pensions modelling.

8.6.1 Alternative scenario one

Impacts on individuals
Increasing the threshold for eligibility to £14,000, excluding micro employers and introducing a three month waiting period would significantly reduce the number of eligible workers, and the final figures for participation in pension saving, compared with both the status quo policy and our recommended scenario. This scenario would reduce the number of people eligible for automatic enrolment by 38 per cent; by contrast, our recommended position reduces eligibility by 10 per cent. Fewer numbers automatically enrolled naturally results in lower private pension incomes in 2050, which would be 34 per cent lower under scenario one compared with the status quo. This is nearly six times greater than the impact of our recommended approach. At the same time, more people will end up needing Pension Credit than would be the case under our proposals, or the status quo policy (Table 8.1).

Lower private pension incomes will have a knock on effect on other benefits, such as Housing Benefit and Council Tax Benefit, and thus cost to the Exchequer in the long term. We estimate that scenario one would result in a 50 per cent smaller saving on these benefits compared with the status quo.

Impacts on employers
Reducing the number of eligible workers leads to lower costs for employers, who face contribution costs with 21 per cent lower under scenario one compared with the status quo. This is compared with a reduction in contributions of four per cent for our recommendations against the status quo policy. Administration costs would also be reduced, since employers will be undertaking fewer automatic enrolment activities. These costs would be reduced by around 40 per cent in year one and then 21 per cent annually in steady state, compared with the status quo policy.

Impacts for the pensions industry and NEST
Assuming charges of 0.5 per cent AMC plus a three per cent contribution charge, under this scenario, half of employers with five-nine employees are not profitable to the pensions industry.

An intervention like NEST would, therefore, still be necessary to achieve 100 per cent coverage under this scenario. However, this option has potentially significant consequences for the number of members in NEST compared with the status quo policy. A significant proportion of the supply gap that NEST is intended to fill would no longer exist. This would begin to undermine the achievement of economies of scale that are necessary to ensure that NEST can both offer a low cost pension to its members and be financially viable in its own right. It is difficult to predict precise volumes for NEST under this scenario, as the decisions of employers and the exact margins of the supply gap become very significant. However, there is a significant risk that government would need to support NEST with loan funding over a much more significant period and, in worst case scenarios, NEST may need an on-going subsidy in order to continue to provide a low cost product to all its members.

An alternative would be to allow charges to rise to increase profitability in the pensions industry, allowing existing providers to meet the supply gap. Our analysis suggests that charges at the stakeholder cap may be sufficient to achieve this, but this is sufficiently marginal that, even with charges at this level, we cannot conclude with any confidence that the entire supply gap would be eradicated.

Impacts on programme costs

Fewer savers under this scenario will lead to less tax relief on pension savings, such that the Exchequer would make savings of around 22 per cent compared with the status quo. However, as previously mentioned there would be comparative costs in the long term in the form of lower savings on Housing and Council Tax benefits and Pension Credit.

Excluding micro employers would result in lower costs relating to The Pensions Regulator, since these employers comprise the highest risk and thus will incur the greatest costs in chasing and enforcing compliance with the duties.

8.6.2 Alternative scenario two

This scenario is more extreme than scenario one, in that it involves excluding all employers with fewer than twenty employees, to illustrate a scenario in which NEST would not be necessary to support the reforms.

Impacts on individuals

This scenario would more than halve the number of people eligible for automatic enrolment, and reduce the total participation in private pension saving post-reform by 39 per cent compared with the status quo. This would lead to a reduction in private pension incomes in 2050 of 61 per cent and an increase in the numbers claiming Pension Credit in 2050 when compared with the status quo policy (Table 8.1). This would also lead to more people needing to claim other benefits in 2050 compared with the status quo.

The absence of NEST offering a low-cost option would also mean that some individuals incur higher charges than they otherwise might experience.

Impacts on employers

Contribution costs would be around 38 per cent lower for employers under scenario two compared with the status quo, and administration costs would be 64 per cent lower in year one and 76 per cent lower annually in steady state, compared with the status quo.

Impacts for the pensions industry

Assuming universally low charges of 0.5 per cent AMC plus a three per cent contribution charge, Chart 7.9 shows that 80 per cent of employers with 20 or more employees would be profitable. Thus under this scenario the pensions market would be able to meet the demand created by automatic enrolment, with 100 per cent coverage. It is likely that the largest employers could be offered charges lower than this.

Impacts on programme costs
This option would result in savings to the Exchequer (in the form of lower tax relief on pension savings) of 39 per cent against the status quo. However, this would be partially offset by longer term costs in the form of greater expenditure on Housing and other benefits. Under this scenario, there would be no cost of providing NEST, which would otherwise be in receipt of a Government loan in the short term. Such extreme eligibility restrictions would undoubtedly result in lower compliance costs; however it is unclear what the scale of these would be, since The Pensions Regulator would need to redesign their approach entirely under this option.

8.6.3 Summary
Our recommended approach balances small reductions in the numbers of savers and amounts of pension savings against slightly reduced burdens for employers, in the form of reduced contribution costs and administrative costs. At the same time, a number of deregulatory changes significantly simplify the automatic enrolment process, improving the experience for employers and making it easier for them to understand and comply with the duties.

The two more extreme scenarios we have considered would be much cheaper for employers and for the Exchequer, albeit some of the gains in lower tax relief would be offset by higher benefit costs in the long term. Scenario one creates a situation where we can neither be confident that NEST would achieve sufficient scale to be financially viable, nor that the entire demand from automatic enrolment would be sufficiently profitable for the pension industry to take up the slack. In scenario two, there would be no need for NEST. However, these cost savings are balanced by significant reductions in the total numbers of savers and reduced pension incomes for those that are automatically enrolled at some point.

8.7 Further considerations for Government

8.7.1 Communications
In addition to the deregulatory changes we are recommending, we feel very strongly that good communications will be key to minimising the burden for employers, and particularly small employers. Automatic enrolment and the various employer duties underlying this are new and potentially complex. We anticipate that there could be a significant burden for employers in simply understanding what they must do in order to comply, and in choosing the best options for them and their employees. Stakeholders have consistently highlighted the importance of good guidance and information to ease burdens on employers, and we agree that this is likely to be central to compliance.

Recommendation:
We recommend that Government focus significant energies on ensuring effective communications to lead up to and accompany the reforms.

In conducting this review we have also highlighted a number of further issues that are out of scope, but we feel are very important.

8.7.2 Regulatory arbitrage

There is an important issue around the difference between contract based and trust based pension schemes. They are regulated differently. That may not have mattered overly much when pension provision was entirely voluntary. But now that it will be compulsory for employers to designate a scheme the different regulation may drive behaviour: there may be regulatory arbitrage. The most serious issue would appear to be around the difference in treatment of people who leave employment early, with trust-based schemes enabling leavers in the first two years to have their contributions refunded, while contract-based schemes do not. In addition, those who stay a little longer and build a pot below £2,000 receive favourable commutation terms in a trust-based scheme. These differences could create a considerable incentive for employers to set up trust-based schemes, and indeed we were told that many employers are exploring such arrangements for just these reasons. How to resolve this is beyond our scope, but it does need to be resolved.

Recommendation:
This is an issue that goes well beyond the scope of this review. But it is an important one and one about which we are very concerned. We recommend that government needs to examine this issue as a matter of some urgency.

8.7.3 DC Risks work

Linked to this point, we are aware that The Pensions Regulator instigated a review of risks in defined contribution schemes in September 2009. Their rationale for the review was a concern that a combination of pre-existing factors relating to defined contribution provision (e.g. high charges, quality of retirement processes and standards etc.) along with the increase in provision through automatic enrolment could lead to an increase in the number of badly run schemes and poorer outcomes for members. The Pensions Regulator will be working with DWP, HM Treasury and the FSA on this project over the coming months.

Recommendation:
We feel that this work is important, and recommend that the Government should continue with work to review whether the existing regulatory regime for the provision of defined contribution workplace pensions remains appropriate in the post automatic enrolment world.

8.7.4 Transfer arrangements

Most people move between employers many times in their working lives, about 11 times on average. If they move between employers with different pension schemes they could easily end up with 11 or more different pension pots on retirement. This is difficult for individuals to deal with and expensive and inefficient for pension providers. But regulation makes moving pensions between one scheme and another very difficult and few people do so. We believe that for the pension reforms to be truly effective it will need to be straightforward, indeed the norm, for people to move their pension pot with them as they move employer.

Recommendation:
We believe that government and regulators need to review this issue as a matter of some urgency.

Annex A
Terms of Reference

Context

The purpose of this review is to build on the work of the Pensions Commission for increasing private pension saving through the introduction of mandatory automatic enrolment into workplace pensions. This Government remains committed to the role of automatic enrolment. However, the review reflects a range of developments since the Turner recommendations were formulated, including:

- The credit crunch in financial markets, the economic downturn and the fiscal deficit.
- A greater understanding of likely costs and the proposed charging structure for NEST.
- The proposed approach and profile for introducing the new employer duties and phasing in of minimum levels of mandatory contributions.
- The proposed review of State Pension age; and
- Other changes such as the further increases in life expectancy and further decline in private sector pension coverage.

Scope

The review will consider:

- Whether the proposed scope for automatic enrolment strikes an appropriate balance between the costs and benefits to both individuals, and employers, or whether the underlying policy objective of increasing private pension saving and balancing those costs and benefits would be better delivered by a different scope for automatic enrolment. In looking for the right group to automatically enrol, the review may among other things explore:
  - The earnings threshold, above which automatic enrolment applies.
  - The introduction of a *de minimis* level for contributions before automatic enrolment applies.

    - The age group to which automatic enrolment should apply.
    - The size of firm to which automatic enrolment should apply; and
    - Whether employees should be automatically enrolled on the day they start work or some later date.
- The availability and capacity of pension providers other than NEST to serve the potential automatically enrolled population.

In light of these conclusions, whether the policy of establishing NEST, as currently envisaged, is the most effective way to deliver future access to workplace pension saving and income security in retirement.

In reaching its conclusions, the review will have regard to the effectiveness of the proposed regime in:

- Tackling pensioner poverty as quickly as possible, including among women pensioners.
- Maximising voluntary private savings and the speed by which this objective can be achieved.
- Minimising the administrative burdens on employers and the impact on existing provision.
- Achieving an effective balance between the achievement of policy objectives, pace of implementation, value for money and risk, and
- Maximising value for money for the Exchequer.

Outcomes
The review should provide a critical analysis of the rationale underpinning the current approach to the programme, identifying whether alternative approaches could improve outcomes or value for money. It will also inform wider discussions on affordability and value for money in the context of the next Spending Review.

Resources
DWP will provide full support to the review, including secretariat support, input on and discussion of policy objectives and possible options, option analysis and economic modelling, and support in drafting papers and reports.

Timing
The review should present its analysis, conclusions and recommendations by 30th September.

Annex B
Formal responses to call for evidence

- Association of British Insurers
- Association of Consulting Actuaries
- Acorn Bowman FIM Limited
- Age UK
- Arc Benefits Limited
- Association of Pension Lawyers
- Association of Convenience Stores
- Aviva
- B&CE Benefit Schemes
- British American Tax
- British Chambers of Commerce
- Buck Consultants
- Capita Hartshead
- CBI
- Chartered Institute of Personnel and Development
- Citizens Advice Bureau
- Cleaning and Support Services Association
- Consumer Financial Education Body
- Co-operative Group
- Cornerstone
- CWC Group

- Department for Education (in respect of the Teachers' Pension Scheme)
- Equality and Human Rights Commission
- Eversheds LLP
- Federation of Small Businesses
- Fidelity International
- Foremost Services
- Friends Provident
- Gabem Management
- Globe Connections Ltd
- Hargreaves Lansdown
- Hewitt
- HISL
- Honister Partners
- Hymans Robertson
- ICAEW
- Institute of Chartered Accountants of Scotland
- Institute of Directors
- Institute of Payroll Professionals
- Investment and Life Assurance Group
- Investment Management Association
- Law Society of Scotland
- Legal & General
- Les Jennison
- Lowdham Leisureworld
- Marks and Spencer
- Mercer
- NAPF
- National Federation of Occupational Pensioners
- Pensions Management Institute
- PriceWaterhouseCoopers
- Prudential
- Randstad UK
- Recruitment and Employment Confederation
- Ros Altmann
- Royal London and Scottish Life

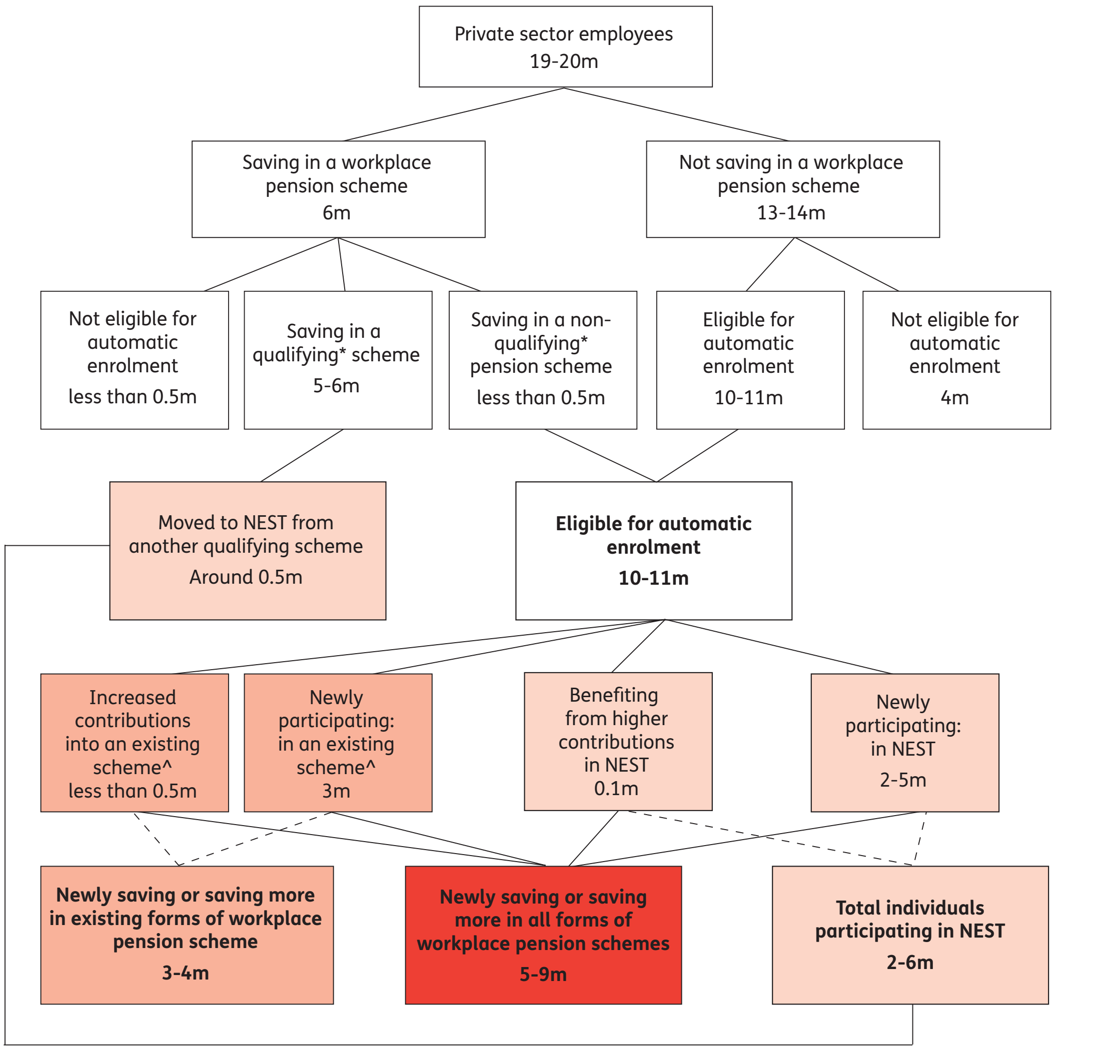
- Royal Society of Arts
- Scottish Widows
- SimplyBiz plc
- Slaughter & May
- SPC
- Standard Life
- Svitzer Marine Ltd
- Tax Incentivised Savings Association
- The Learn Centre
- The Pensions Advisory Service
- The Pensions Regulator
- Towers Watson
- TUC
- UNISON
- Which?
- Wincanton plc
- Zurich Financial Services

Annex C
Further analysis

C.1 Individuals

C.1.1 Impact of automatic enrolment

Chart C.1.1: How participation estimates are constructed



Note: Ranges are rounded to the nearest million, and therefore may not sum.

* Taking an employer contribution of at least 3 per cent into a current workplace pension scheme as a proxy for a defined contribution scheme that is likely to qualify under the Pensions Act 2008. We have assumed that all defined benefit schemes qualify in this analysis.

^ This is an existing or newly set up workplace pension scheme, other than NEST.

Source: Department of Work and Pensions modelling.

For further detail exploring the methodology around this, please see:
http://www.legislation.gov.uk/uksi/2010/917/pdfs/uksiem_20100917_en.pdf.

C.1.2 Replacement rates: illustrative case studies

To show the potential impacts of pensions saving and state interventions, we set out several example case studies below. These set out what a person in this situation is likely to receive if they saved for a pension in the same way. The calculations assume that the lump sum is annuitised in the first year of retirement. Sensitivity testing of real fund growth using 1.5 per cent and 3.5 per cent are presented in brackets after main results, which use real fund growth of 2.2 per cent. All figures are in current earnings terms.

Case study 1: A low earner with dynamic earnings profile, starting work on £11,000 at age 25 increasing to £21,000 by age 50 retires at 68:

- Their net income at retirement is £205 per week (£203-£211) and £188 per week (£186-£193) ten years after retirement. The corresponding figures if they had not saved are £181 per week and £168 per week. They are eligible for Council Tax Benefit whether or not they have saved and become eligible for Pension Credit in their mid-70s if they had not saved.
- The net replacement rate increases from 55 per cent to 62 per cent (61–63 per cent) with saving. Income-related benefits contribute 2 per cent (2–1 per cent) to replacement rate with saving and 4 per cent without saving.
- The payback for saving is £1.90 (£1.68–£2.42) for each £1. The tax free lump sum available at the point of retirement is worth £9,600 (£8,600–£12,100).

Case study 2: Early retiree: lower earner (71 per cent of median earnings), starts saving at 25, retires at 55, annuitises at 68:

- Their net income at retirement is £200 per week (£197–£205) and £183 per week (£180–£188) 10 years after retirement. The corresponding figures if they had not saved are £183 per week and £169 per week. They are eligible for Council Tax Benefit whether or not they have saved and become eligible for Pension Credit in their mid-70s if they had not saved.
- The net replacement rate increases from 63 per cent to 68 per cent (68–70 per cent) with saving. Income-related benefits contribute 3 per cent (3–2 per cent) to replacement rate with saving and 4 per cent without saving.
- The payback for saving is £2.25 (£1.84–£3.24) for each £1. The tax free lump sum available at the point of retirement is worth £6,400 (£5,400–£9,000).

Case study 3: Couple: lower earning man plus median earning woman who takes a 7 year career break in late 20s/early 30s to raise children:

- Their net income at retirement is £409 per week (£402–£426) and £366 per week (£360–£382) 10 years after retirement. The corresponding figures if they had not saved are £344 per week and £313 per week. They become eligible for Council Tax Benefit in their mid-70s if they had not saved.
- The net replacement rate increases from 51 per cent to 60 per cent (59–63 per cent) with saving.
- The payback for saving is £2.41 (£2.11–£3.11) for each £1. The tax free lump sum available at the point of retirement is worth £22,100 (£19,600–£28,300).

Note: figures are in constant earnings terms, and income does not keep pace with earnings over retirement. Whilst Basic State Pension (BSP) rises by earnings (generally under triple guarantee earnings are the highest of the 3 options) the other parts of income normally rises by prices or are flat in earnings terms (level annuity) so overall income declines relative to earnings over time.

The figures set out in the case studies are important as they show the potential impact of private pensions saving on those who are automatically enrolled.

As can be seen in case study 2, a man on the national minimum wage for all of his working life potentially risks seeing little return for his saving: if he saved in a private pension, the difference in his income in retirement is around four-six per cent. It is likely that as private pension income does not keep pace with earnings over retirement, whilst Basic State Pension (BSP) does rise by earnings, that the replacement rate will decrease over time.

The lower earner with a dynamic earnings profile (case study 1) experiences a greater return from saving, compared to the man on the national minimum wage (case study 2), due to a lower interaction with means-tested benefits. Private saving raises his net replacement rate from 55 per cent to 62 per cent, although the bulk of his pension income still comes from the State Pension.

The case studies above also show the impact that variable investment returns have on pension outcomes. The early retiree benefits most (proportionally) from higher fund growth since their savings do not get any extra contributions once they stop working, they just increase through compounded investment return. For most of the individuals modelled above the effect of changing fund growth from 1.5 per cent to 3.5 per cent varies the net replacement rate by around three percentage points.

C.2 Employers

C.2.1 Employer processes under the reforms

This section provides further information on the tasks that must be undertaken by employers in order to comply with the new duties.

Identifying eligible workers and jobholders

Before their staging date, the employer must identify what pension provision they must have in place with respect to different classes of worker, since different employees may have different rights under the Pensions Act 2008. Box C.2.1.1 gives more details of different classes of worker.

Box C.2.1.1

Eligible jobholders must be automatically enrolled into a qualifying automatic enrolment scheme. These are individuals who meet the following criteria:

- Works under a contract of employment or has a contract to perform work or services personally and is not undertaking the work as part of their own business.
- Ordinarily works in Great Britain.
- Is aged between 22 and State Pension age.
- Have qualifying earnings payable by the employer in the relevant pay reference period.

Jobholders who are aged between 16 and 21 but otherwise meet the criteria above may choose to opt into a pension scheme. In this case, the employer must enrol them in a qualifying scheme and provide at least the minimum employer contribution.

Workers who do not meet the definition of jobholder (or eligible jobholder), but nevertheless meet certain criteria, may opt into a pension scheme. The employer is obliged to provide a pension scheme and process any employee contributions, but does not have to pay employer contributions. The worker must be:

- Working under a contract of employment or has a contract to perform work or services personally and is not undertaking the work as part of their own business.
- Ordinarily works in Great Britain.
- Is aged between 16 and 75.
- Does not have qualifying earnings.

If an employee does not meet the necessary criteria to be defined as an eligible "worker", the employer is not obliged to provide them with access to a pension scheme. There are very few circumstances where an employee is not classified as a worker. These include:

- Single person directors where the company has no other employees.
- Armed forces and members of the Combined Cadet Force, Sea Cadet Corps, Army Cadet Force and Air Training Corps.

Setting up a qualifying scheme

If the employer identifies that they have at least one employee that is eligible to be automatically enrolled or to opt into a qualifying scheme, they must then ensure that they have an appropriate scheme in place. Schemes used for automatic enrolment versus those used for employees to opt in to have slightly different quality criteria.

The majority of employers in Britain do not already provide a pension, and so will have to set up a pension scheme for the first time. The majority will seek advice about the right scheme to use for their circumstances.[85]

Box C.2.1.2: Employers who already provide pensions

If the employer already provides a pension scheme to some, or all, of its staff, they have a number of options:

- Use their existing scheme for automatic enrolment (provided it meets the qualifying and automatic enrolment criteria). Changes to the scheme rules may be required and the employer should discuss this with the trustees, managers or provider of the scheme.
- Use part or parts of the scheme for different categories of members, so that only a part of the scheme needs to be qualifying and able to be used for automatic enrolment.
- Use their existing scheme as a qualifying scheme for existing members, and set up an alternative pension scheme to fulfil their automatic enrolment duties.
- Set up an alternative pension scheme to fulfil their automatic enrolment duties for all their eligible jobholders.

Calculation of contributions for automatic enrolment must be based on a band of qualifying earnings or equivalent. Where the employer wishes to use an existing scheme which calculates contributions on a different basis, for instance basic pay, total contributions need to be equivalent to a minimum of eight per cent of qualifying earnings, with at least three per cent coming from the employer. DWP is currently working with employers and the pensions industry to design a simple process for employers with existing high quality schemes to 'certify' that their scheme qualifies for automatic enrolment. A simple certification system is one of our core priorities for minimising regulatory burdens on employers and is considered further in Chapter 6.

Changes to payroll and other administration

The employer may need to make a number of changes to payroll, to ensure the necessary capabilities to administer automatic enrolment. Box C.2.1.3 sets out the changes employers may need to make to payroll systems.

85 Eight in ten micro employers said they would seek advice on how to respond to the reforms; Grant C, Fitzpatrick A, Sinclair P and Donovan JL, 2008, *Employers' attitudes and likely reactions to the workplace pension reforms 2007: Report of a quantitative survey,* DWP research report number 546.

Box C.2.1.3: Changes to payroll

- Determine whether tax relief is to be given at source (contributions deducted from net pay) or under net pay arrangements (contributions deducted from gross pay), and build this into calculations.
- Calculate the correct amount of employer and member contributions and pay them over to the scheme; this includes deducting contributions for the very first pay reference period, during the joining window whilst membership is still being set up.
- For employees who become eligible jobholders part way through a pay reference period the employer will need to be able to make part-period calculations of contributions.
- Build into payroll a schedule of payments setting out the contribution amounts and due dates for paying member contributions and employer contributions to the scheme.
- The employer should build into their payroll processes the ability to refund any contributions deducted from an eligible jobholder who opts out during the opt out period.

When the legislation first applies (on the employer's staging date) it is likely there will be a number of eligible jobholders to be enrolled at the same time. This means that payroll should be set up ready to make deductions and pay across to the scheme from the staging date. Employers who operate a weekly payroll will need to allow enough time to set this up because, if the eligible jobholder is making contributions, deductions must be made from the first week.

Deciding when to automatically enrol eligible jobholders

An individual's automatic enrolment date is the date they first meet the criteria whilst working for that employer, unless they are already an active member of a qualifying scheme. This date may be:

- The employer's staging date (assuming the person is an eligible jobholder on that date).
- The date the person takes up employment with that firm (assuming they are an eligible jobholder on that date).
- Whilst in employment, and once the duties apply to that employer, the first time the person has qualifying earnings (if they already meet the age criterion).
- Whilst in employment, and once the duties apply to that employer, the person turns 22 years old (if they already meet the earnings criterion).

However, Box C.2.1.4 sets out three choices some employers face, depending on their circumstances.

Box C.2.1.4: Employer choices about when to automatically enrol

- Any employer staged into the duties on or after 1 November 2012 may choose to bring their staging date forward to any other date specified as a staging date in regulations (i.e. between 1 October 2012 and 1 September 2016). They must ensure they are able to make appropriate pension arrangements, and have informed the Pensions Regulator of these arrangements before exercising this choice.
- An employer with a defined benefit scheme or hybrid scheme may take advantage of transitional arrangements that allow them to defer automatically enrolling individuals who had been eligible to join the scheme before the employer's staging date (but who had chosen not to join).
- An employer using a scheme that meets certain higher quality criteria may choose to postpone automatically enrolling jobholders into that scheme for three months, as long as they maintain those higher quality standards for at least three months after enrolling the individual.

The employer must decide what the automatic enrolment date should be for each eligible jobholder, and take action to ensure they are enrolled at the right time. An additional complexity for the employer is that staging dates are determined on the basis of the employer's PAYE scheme reference. So where an employer has more than one PAYE scheme, they must identify the largest one and determine the associated staging date, which will be an unfamiliar task.

Information requirements

As a part of the automatic enrolment process, the employer must provide certain information to the eligible jobholder, to the scheme, and to individuals eligible to opt in to the scheme:

- The eligible jobholder must be informed that they are being automatically enrolled and given information about the scheme and the amount of contributions coming from them, from their employer, and from tax relief. They must be informed of their right to opt out.
- The postponed eligible jobholder must be given information within one month of the original automatic enrolment date, informing them about the postponement.
- Eligible jobholders who are subject to transitional arrangements for defined benefit and hybrid schemes must be informed of these arrangements and the date on which they will be enrolled into the scheme.
- Employees who are eligible to opt in must be given information about their right to opt in and what this means.
- The employer must provide their chosen pension scheme or pension provider with personal information about the eligible jobholder within one month of the person's automatic enrolment date.

Registration with TPR

Employers are required to tell the Pensions Regulator what they have done to comply with the automatic enrolment duties, within two months of the employer's staging date. This includes providing information about the employer themselves, their chosen pension scheme or schemes, and the numbers of people who: have been automatically enrolled; who have been postponed; are subject to DB/hybrid transitional arrangements; who were pre-existing members; or are not eligible for automatic enrolment.

C.2.2 Scheme quality

Table C.2.2.1: Annual Management Charges in workplace personal pensions, by scheme size

Annual Management Charge	5-49 members	50-149 members	150+ members
			Column percentage
up to 0.39%	3	2	8
0.4%-0.59%	11	15	16
0.6%-0.79%	16	25	33
0.8%-0.99%	18	32	35
1%+	53	26	8

Source: Croll A, Vargeson E and Lewis A, 2010, "Charging levels and structures in money purchase pension schemes: Report of a quantitative survey", Department for Work and Pensions Research Report No 630.

Table C.2.2.2: Pension scheme membership by contribution rate and scheme type

Current provision	Percentage Proportion of employer's workforce that have joined the scheme
Contribution rate (all scheme types):	
No contributions	32
Average rate of 0.1-2.9%	43
Average rate of 3.0%	46
Average rate of 3.1-5.9%	60
Average rate of 6.0%+	63
Scheme type (all contribution rates):	
Stakeholder schemes	20
GPPs	45
Occupational schemes (DB + DC)	68

Base: all employers with workplace pension provision (excluding contributions to personal pensions only).

Source: Bewley H and Forth J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

Table C.2.2.3: Use of scheme eligibility restrictions by firm size

							Column percentage
	1 to 4	5 to 49	50-249	250-499	500 or more	All	All
All employees in organisation (and no waiting period)	54	57	44	44	48	55	54
All with a minimum length of service only	29	34	45	40	43	33	33
All with a minimum length of service and other eligibility criteria	4	4	7	5	4	4	4
Some other eligibility criteria	11	3	4	11	5	7	8
Don't know/not stated	2	1	*	*	*	2	1
Unweighted base	*121*	*409*	*444*	*294*	*413*	*1,681*	*1,941*
Weighted base	*369*	*376*	*41*	*4*	*12*	*801*	*801*

Base: All providers with an open pension scheme.

Source: Grant C, Fitzpatrick A, Sinclair P and Donovan J, 2008, "Employers' attitudes and likely reactions to the workplace pension reforms 2007: Report of a quantitative survey", Department for Work and Pensions Research Report No 546.

Table C.2.2.4: Use of scheme eligibility restrictions by current contribution rates

					Column percentage
	3% or more	Less than 3%	All contributors	Non-contributors	All
All employees in organisation (and no waiting period)	47	55	48	62	55
All with a minimum length of service only	37	25	36	29	33
All with a minimum length of service and other eligibility criteria	5	17	6	3	4
Some other eligibility criteria	9	*	9	5	7
Don't know/not stated	2	2	2	2	2
Unweighted base	*1,079*	*78*	*1,193*	*488*	*1,681*
Weighted base	*365*	*30*	*429*	*372*	*801*

Base: All providers with an open pension scheme.

Source: Grant C, Fitzpatrick A, Sinclair P and Donovan J, 2008, "Employers' attitudes and likely reactions to the workplace pension reforms 2007: Report of a quantitative survey", Department for Work and Pensions Research Report No 546.

Table C.2.2.5: Methods for joining pension schemes

Joining mechanism	**Employers** *column percentage*	**Proportion of the employer's eligible workforce that joined the scheme** *cell percentage*
Automatic membership (not as part of contract)	2	[77]
Automatic membership (as part of contract)	4	79
Make a yes/no declaration	32	41
Sign a pre-completed form	7	45
Complete a detailed form	37	34
Something else	7	38
Don't know	11	48
All	100	**42**
Unweighted base	*1681*	
Weighted base	*801*	

Source: Grant C, Fitzpatrick A, Sinclair P and Donovan J, 2008, "Employers' attitudes and likely reactions to the workplace pension reforms 2007: Report of a quantitative survey", Department for Work and Pensions Research Report No 546.
Number in square brackets are percentages based on fewer than 50 observations.

C.2.3 Estimating administrative costs

The standard cost model methodology takes the regulations and breaks them down into the individual activities that an employer has to complete. The cost of each activity will depend on:

- The time taken to carry out the activity.
- The person carrying out the activity and their effective wage per hour, or the cost of outsourcing the activity to a specialist organisation; and
- The number of times the activity has to be completed.

The fundamental concept and unit of measurement is a normally efficient business. The costs exclude business as usual costs that an employer may already be incurring. The employer administrative costs take into account the range of new activities employers will need to perform to fulfil their legal obligations. These can be categorised into four high level groups.

Preparing for start-up:

- Investigating whether existing schemes meet the quality criteria.
- Decision makers meeting to discuss changes to business strategy due to the reforms.
- Making an arrangement with a pension scheme so that employees can be enrolled from the automatic enrolment date.
- Adapting or purchasing in-house or internal payment systems.

- Training staff to carry out the administrative processes; and
- Communicating with all employees about the firm's response to the reforms.

Registration:
- Receiving written confirmation from the Pensions Regulator about the firm's automatic enrolment date 12 and three months before that date.
- Registering for the PAYE service with the Government Gateway if payroll is outsourced.
- Registering with the Pensions Regulator each PAYE scheme, giving details of the pension scheme(s) used to comply with the duties; and
- Re-registering once every three years, verifying the details of the pension scheme(s) being used.

Enrolment:
- Providing information to existing members of qualifying schemes.
- Providing information to jobholders whose automatic enrolment is being postponed.
- Enrolling eligible jobholders, providing them with the required information and providing their details to the pension scheme.
- Dealing with opt outs and refunding any contributions deducted by the employer before the opt out form was received; and
- Providing information to jobholders not eligible for automatic enrolment and workers without qualifying earnings about their right to opt in to pensions saving.

Collection and administration:
- The calculation and collection of contributions from employees' pay with effect from day one.
- Payment of contributions to the pension scheme.
- Dealing with queries about deductions; and
- Processing requests to cease pension saving.

The estimates of costs for employers as a result of the reforms were the result of a cross-Government working group which refined the estimates of the cost impacts for employers presented in the December 2006 White Paper Personal Accounts: a new way to save. The working group comprised economists from the Department of Work and Pensions, the Enterprise Directorate at the Department for Business, Enterprise and Regulatory Reform (BERR), and the Better Regulation Executive.

The working group:
- Systematically reviewed all of the assumptions underlying the estimates.
- Incorporated evidence from the latest data sources including the Annual Survey of Hours and Earnings and evidence from a Department of Work and Pension's survey of employer attitudes and likely responses to reform; and

- Commissioned two new research projects on the costs to employers:
  - A series of focus groups with employers of different sizes to help validate our estimates of the cost of internally administering monthly contributions.[86] This research found the estimates to be broadly accurate and, if anything, slightly high; and
  - A small telephone-based survey to help establish the additional costs of administering monthly contributions to employers who currently outsource their payroll functions.[87]

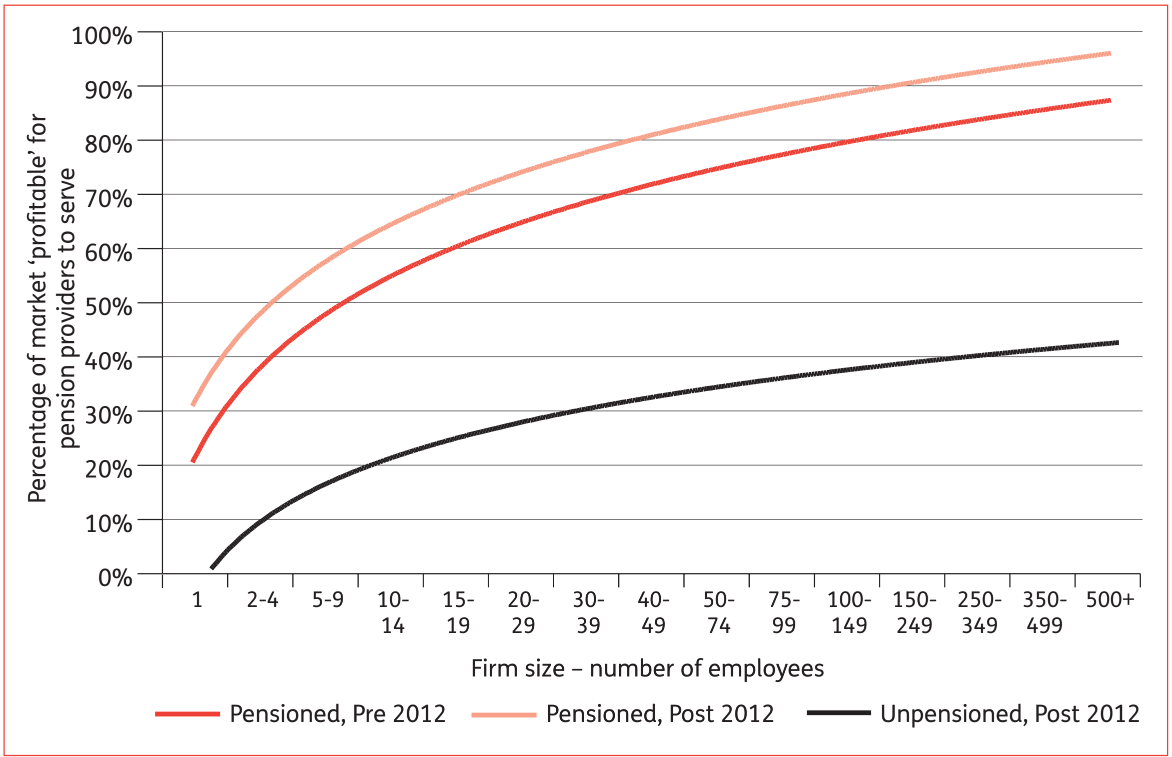
86 Stone A, Allison G, Braidford P, Houston M, (Durham University) 2007, "*Anticipated administrative burdens on businesses of proposed personal accounts arrangements*". Available at: http://www.berr.gov.uk/files/file42160.doc

87 Butters S, North D, Vickers I, Engelbert S, Macauley P, (Middlesex University Business School) 2007, *Enquiry for BERR and DWP on the predicted costs of additional payroll services to support personal account pensions*. Available at: http://www.berr.gov.uk/files/file42159.doc

C.3 Industry

C.3.1 How will automatic enrolment affect profitability in the market?

Chart C.3.1.1: Profitability of all firms before and after the introduction of automatic enrolment, assuming charges of 0.5 per cent AMC plus a three per cent contribution charge



Source: Department for Work and Pensions modelling.

C.3.2 Analysis of key factors determining how ‘profitable’ schemes are

Box C.3.2.1: Modelling profitability

In 2009 DWP commissioned external consultants, Charles River Associates, to develop a model of profitability in the workplace personal pensions market, with the intention of building on the Pension Commission’s analysis.[88] By modelling both costs and revenues, the model assesses whether or not it is profitable for the private sector to offer a new pension to a particular type of firm. The model uses primary research with pension providers and is updated to reflect changes to policy and understanding of industry reactions.

The model begins by analysing pension provision in a cross-section of UK employers, based on the DWP’s Employers Pension Provision survey. It introduces into this ‘churn’ analysis from the Office for National Statistics’ (ONS’s) Labour Force Survey, salary analysis from the ONS’s Annual Survey of Hours and Earnings and charge rate and structure assumptions, participation rate assumptions and contribution rate assumptions from the DWP to predict:

- The cost of setting up new schemes to cover eligible employees.
- The volumes and persistency (relating to employee turnover, or ‘churn’) of contributions into each scheme; and therefore
- The present value of revenue streams to each scheme provider.

Based on the cost of provision to each employer and the revenues each employer is expected to generate for pension providers, a ‘Net Present Value’ statistic is calculated for each employer, evaluating whether or not over a given horizon a provider would be able to recover their costs at reasonable charge levels, and the magnitude of the difference between costs and revenues. This information is aggregated in our charts to give the proportion of employers in each size class on whom providers would be able to recover their costs, and so who might be expected to be offered provision in a well-functioning open market.

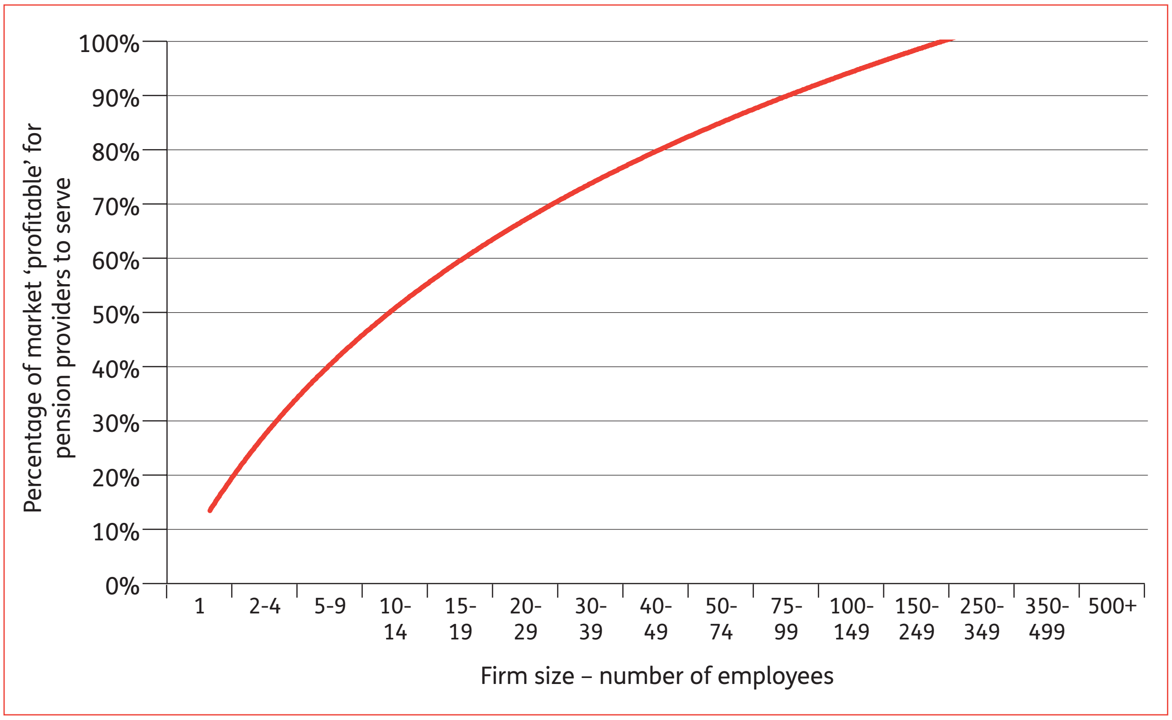
The model and its underpinning assumptions go through thorough quality assurance processes within DWP. To reflect the uncertainty surrounding the response of the pension industry to the reforms and the assumptions used in the model, scenarios are being developed to put ranges around the modelled results.

88 Malcolm K, Wilsdon T and Xie C, 2009, Workplace Pension Market Model, DWP working paper 74.

Employer size

Pension schemes will be profitable to providers when larger funds are accrued and maintained over longer periods. The number of members also matters; higher volumes not only increase total contributions but also spread the fixed costs of set up over more members. Thus employer size can be a proxy for membership, and potential profitability. Chart C.3.2.1 shows a very strong positive association between the number of employees in a company and the likelihood that a company scheme will be profitable. So around three quarters of employers who have 20-29 employees would be profitable at the Stakeholder Charge Cap, compared with only around two in ten employers who have two-four employees.

Chart C.3.2.1: Employer size and profitability, assuming charges at the Stakeholder Charge Cap and average take up of 70 per cent



Source: Department for Work and Pensions modelling.

In considering this analysis, it is worth bearing in mind the highly uneven distribution of employers and employees in the UK. Only around six per cent of employers have 20 or more employees. However, these companies employ just over 70 per cent of the working population, with 43 per cent of workers being employed by the very largest employers (with 500 or more employees).

Worker salaries

Chart C.3.2.2 shows a very strong relationship between average pay and profitability. Employers who offer an average salary below £16,000 are very rarely profitable to pension providers; around half those paying between £16,000 and £20,000 are profitable; the majority who pay more than this are profitable.

However, we must remember that this is an unusual way of breaking down the employer population, which cannot really give a sense of how profitable the market is overall. Most employers, and particularly large employers, will have employees across a range of salaries, and so companies with an average salary of over £50,000 (or even over £30,000) will be relatively rare.

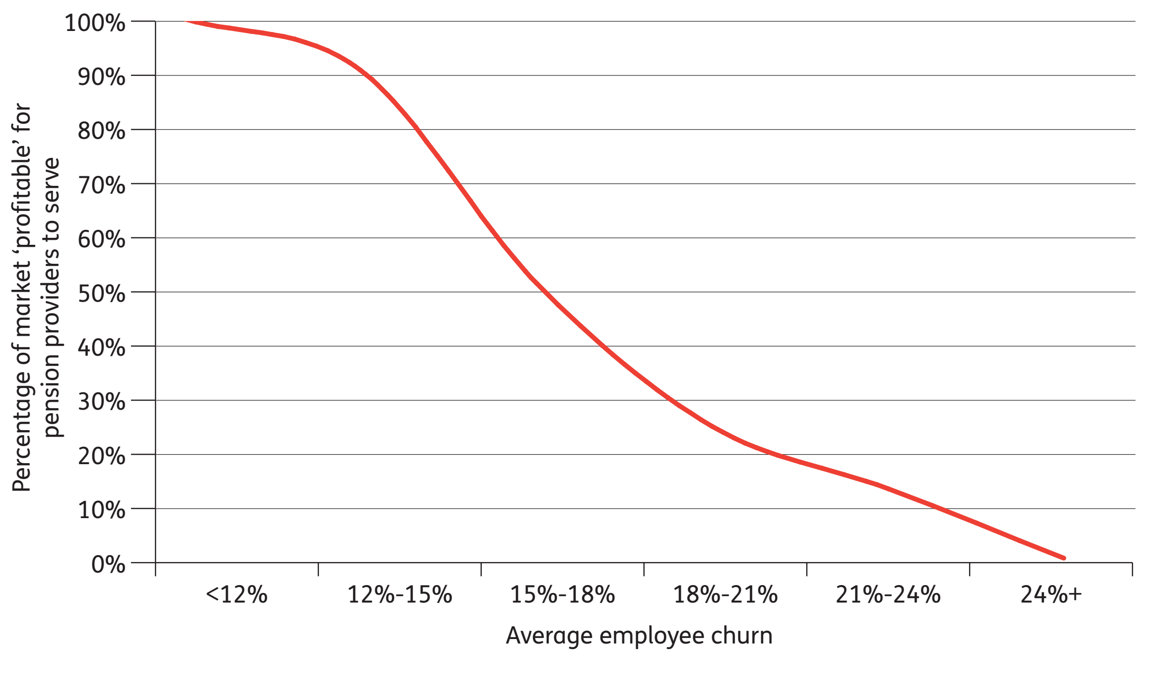
Chart C.3.2.2: Pay and profitability, assuming charges at the Stakeholder Charge Cap and participation of 70 per cent

Source: Department for Work and Pensions modelling.

Jobchurn

We have discussed the potential impact of member persistency on profitability. Members may cease being an active member of a pension scheme either because they stop making contributions into that scheme, or because they leave that employer. Whilst we do not have robust data on the former, Chart C.3.2.3 shows a clear relationship between job churn (in terms of the number of individuals leaving an employer per year) and profitability. Almost all employers with the lowest jobchurn are profitable, compared with less than ten per cent of the employers with the highest jobchurn.

Chart C.3.2.3: Job churn and profitability, assuming charges at the Stakeholder Charge Cap



Source: Department for Work and Pensions modelling.

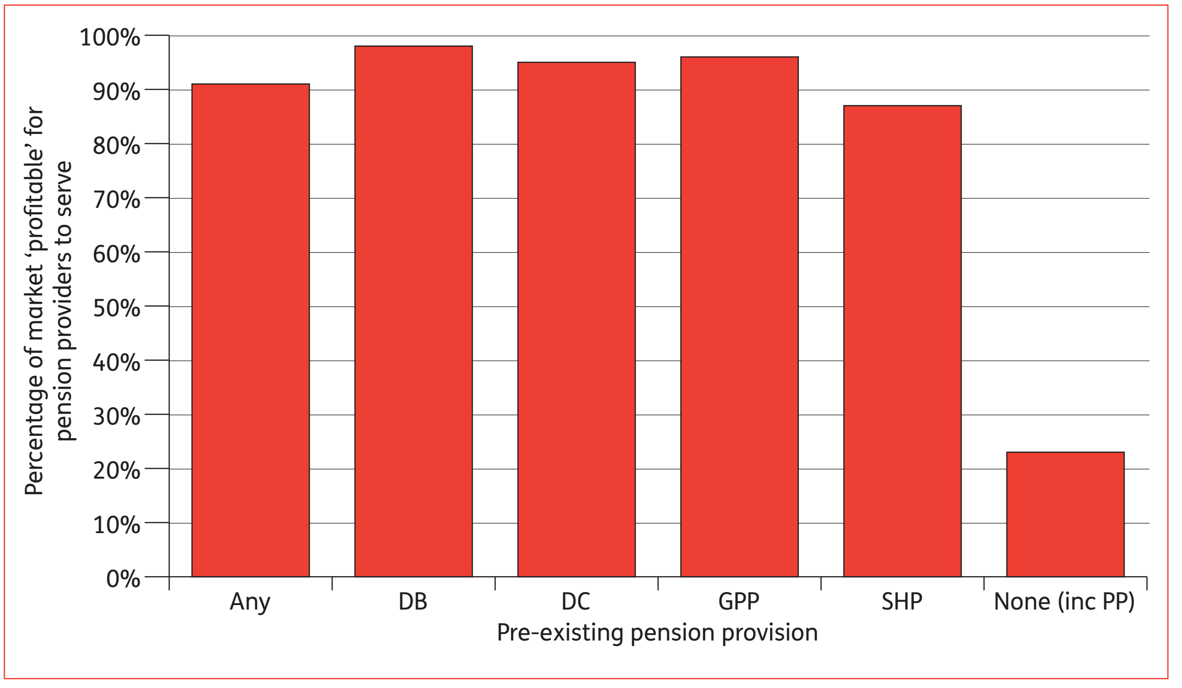
Sectors with low average salaries and a greater prevalence of seasonal and/or part time working (resulting in higher jobchurn), such as retailers and hotels and restaurants, are less likely to generate profits for pension providers than other sectors.

Current pension provision

Chart C.3.2.4 shows that around 90 per cent of employers who currently offer any kind of pension scheme to some of their employees will be profitable to pension providers post-reform under the stakeholder charge cap. Of those who offer a defined benefit or GPP scheme, almost all are profitable, compared with 23 per cent of those who offer no pension.

It seems likely that types of provision will correlate strongly with firm size, average salaries and inversely with staff turnover, and so that existing provision will be a marker for other features. This analysis also suggests that the workplace pensions market is currently functioning well in the economic sense: those employers on whom providers can recover costs are well covered; those on whom providers could expect to make a loss are generally not covered.

Chart C.3.2.4: Current provision and profitability, assuming charges at the Stakeholder Charge Cap

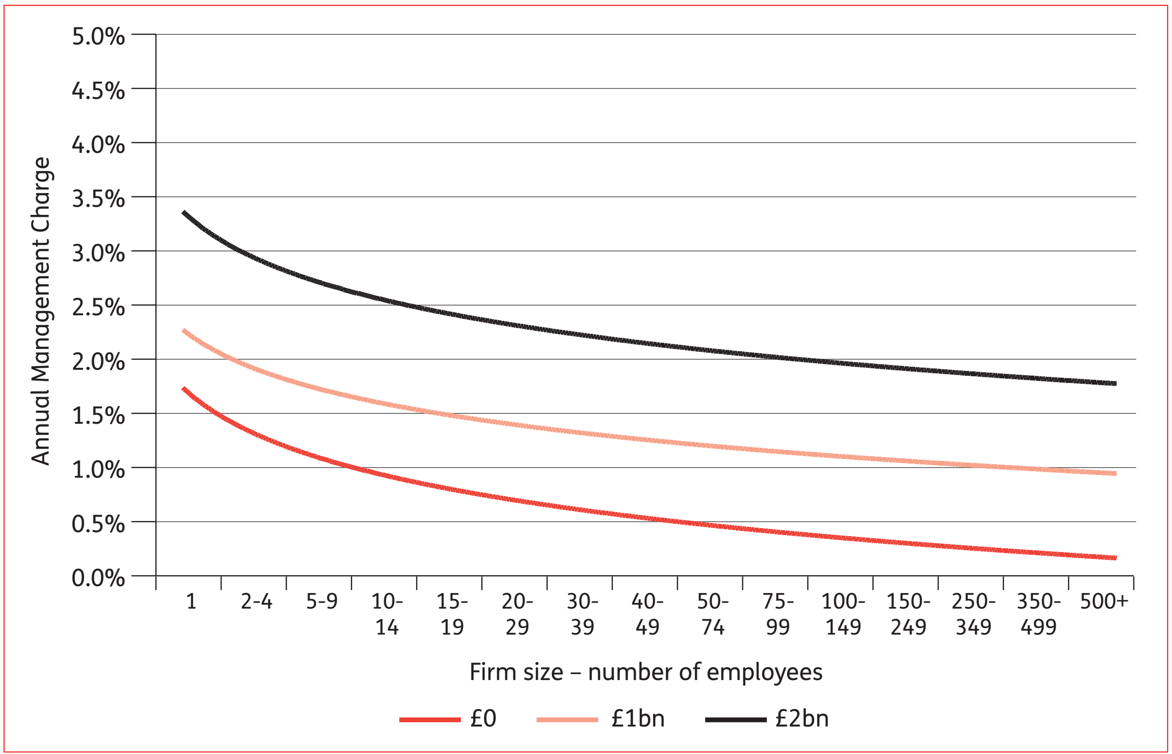


Source: Department for Work and Pensions modelling.

It is striking that the maximum profitability shown in each of these analyses varies quite substantially. This is likely to be a result of cutting the employer population up in different ways, which creates slightly odd distributions and masks other effects. Profitability will depend on a combination of factors, which may not be correlated within groups depending on how the data is cut, resulting in apparently low or high profitability across the whole population.

C.3.3 Free market response: Master-trusts

Chart C3.3.1: Impacts of pooling employers by size: AMC levels needed to generate £0 NPV, £1bn profit, or £2bn profit across pools



Source: Department for Work and Pensions modelling.

C.4 Target Group

C.4.1 The Earnings Threshold

To determine the impact on individuals, we need to understand the characteristics of eligible employees without a qualifying pension. This section provides further analysis of earnings of these individuals (the target group) by gender, ethnicity and disability status.

Gender

Overall there are more men than women in the target group. Women are more likely to have broken work histories due to economic inactivity, such as caring responsibilities. Individuals with longer, unbroken periods of pensions saving are more likely to yield better returns in later life than those who start saving later or who have broken pension provision.

Table C.4.1.1 shows gross earnings for the target group split by gender. 46 per cent of women in the target group earn less than £14,000, compared with 17 per cent of men.

Table C.4.1.1: Target group by earnings and gender

						Row percentage
	Individual gross earnings					
Gender	£5,715-£7,335	£7,336-£9,999	£10,000-£13,999	£14,000-£19,999	£20,000-£24,999	£25,000 and over
Male	2	4	11	27	19	37
Female	10	15	21	26	12	15
All	6	9	16	27	16	27

Source: Family Resources Survey, United Kingdom 2005-06, Department for Work and Pensions.

Ethnicity

Table C.4.1.2 shows gross earnings by ethnicity for the target group. 33 per cent of White individuals in the target group earn less than £14,000 compared with 34 per cent of those from non-White ethnic groups.

Table C.4.1.2: Target group by earnings and ethnic group

						Row percentage
	Individual gross earnings					
Ethnic Group	£5,715-£7,335	£7,336-£9,999	£10,000-£13,999	£14,000-£19,999	£20,000-£24,999	£25,000 and over
White	6	10	16	27	15	26
Mixed	5	10	13	27	18	27
Indian	6	7	18	24	18	27
Pakistani and Bangladeshi	9	13	26	24	12	16
Black or Black British	6	7	14	25	17	30
Other Ethnic Groups	6	9	19	20	14	33
All	6	9	16	26	15	26

Source: Family Resources Survey, United Kingdom 2003-04, 2004-05, 2005-06, Department for Work and Pensions.

Disability

Table C.4.1.3 shows gross earnings for the target group by disability status. Disabled employees are over represented amongst the lowest income bands: 39 per cent of the target group who are disabled have gross earnings of less than £14,000, compared with 29 per cent of the non-disabled. 12 per cent of the target group are disabled.

Table C.4.1.3: Target group by earnings and disability status

						Row percentage
	Individual gross earnings					
Disability status	**£5,715-£7,335**	**£7,336-£9,999**	**£10,000-£13,999**	**£14,000-£19,999**	**£20,000-£24,999**	**£25,000 and over**
Disabled	8	12	19	26	14	21
Not disabled	5	9	15	27	16	28
All	6	9	16	27	16	27

Source: Family Resources Survey, United Kingdom 2005-06, Department for Work and Pensions.

C.4.2 Impact of separating the enrolment threshold and the band on which contributions are calculated

It is important to consider the impact on individuals of **separating the enrolment threshold** (at £7,336, £10,000 or £14,000) and the **band on which contributions are calculated** (£5,715 to £38,185). The primary impact of this is that the individual will experience a 'cliff edge' of contributions when their earnings increase such that they are over the enrolment threshold. This is where they feel a strong relative effect on net pay from making pension contributions on earnings over £5,715, in some instances resulting in a small nominal loss of net pay. Employers will also experience this cliff edge, through mandatory employer pension contributions increasing the total remuneration given to the individual by £4, £11 or £21 a month if the threshold rises to £7,336, £10,000 or £14,000.

Chart C.4.2.1: Impact on Employees and Employers of Meeting £10,000 Eligibility Criteria

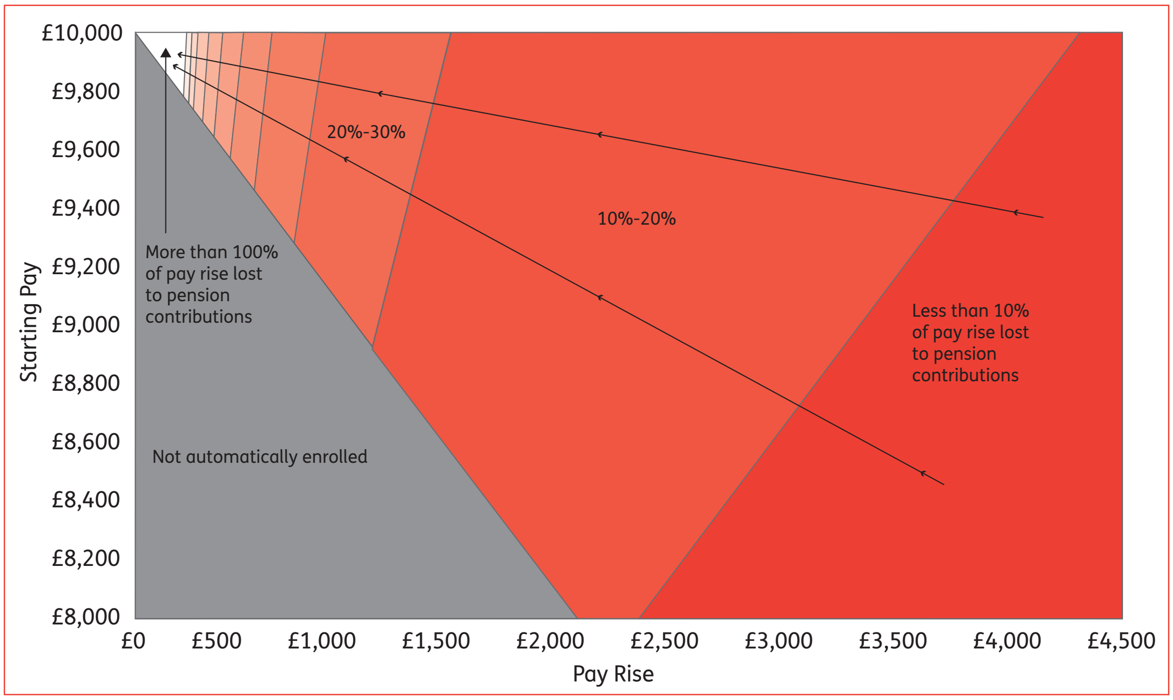
The main relevance of the cliff edge to individuals comes when they experience a pay rise taking their earnings over the enrolment threshold. When someone starts earning at least £7,336, £10,000 or £14,000 they could see a fall in their net pay of up to £5, £14 or £28 per month as they start paying pension contributions (four per cent on earnings above £5,715). This equates to a weekly net pay decrease of just £1, £3 or £6. (It should be noted that they would only see the full fall if they went from earning £10,000 to £10,001. Most people will have a smaller or no loss in net pay).

There is a risk that this counterintuitive reduction in take home pay at the time of a pay rise could increase the likelihood of individuals opting out of their scheme due to affordability. By looking at the proportion of any pay rise that would go towards pension contributions – the amount of the pay rise that the individual "loses" from their visible pay increase – it is clear that **few people could be perceived as being significantly adversely affected in this way**.

It is unlikely for an individual to experience a net pay decrease, where they contribute more into a pension than their pay rise was worth. In order for this to happen the individual would have had to have been earning between £9,750 and £10,000, and had a pay rise of less than £230. It is expected that employers will generally seek to avoid this position arising.

If an individual receives a pay rise of 10 per cent (which is approximately what you might expect to receive with a promotion) to take their earnings over £10,000, they would lose between 25 per cent and 30 per cent of their pay rise to pension contributions. When the pay rise is over more than 10 per cent the amount lost to pension contributions is minimal and the cliff edge becomes negligible.

Chart C.4.2.2 Deciles of Proportion of Gross Pay Rise Lost to Pension Contributions



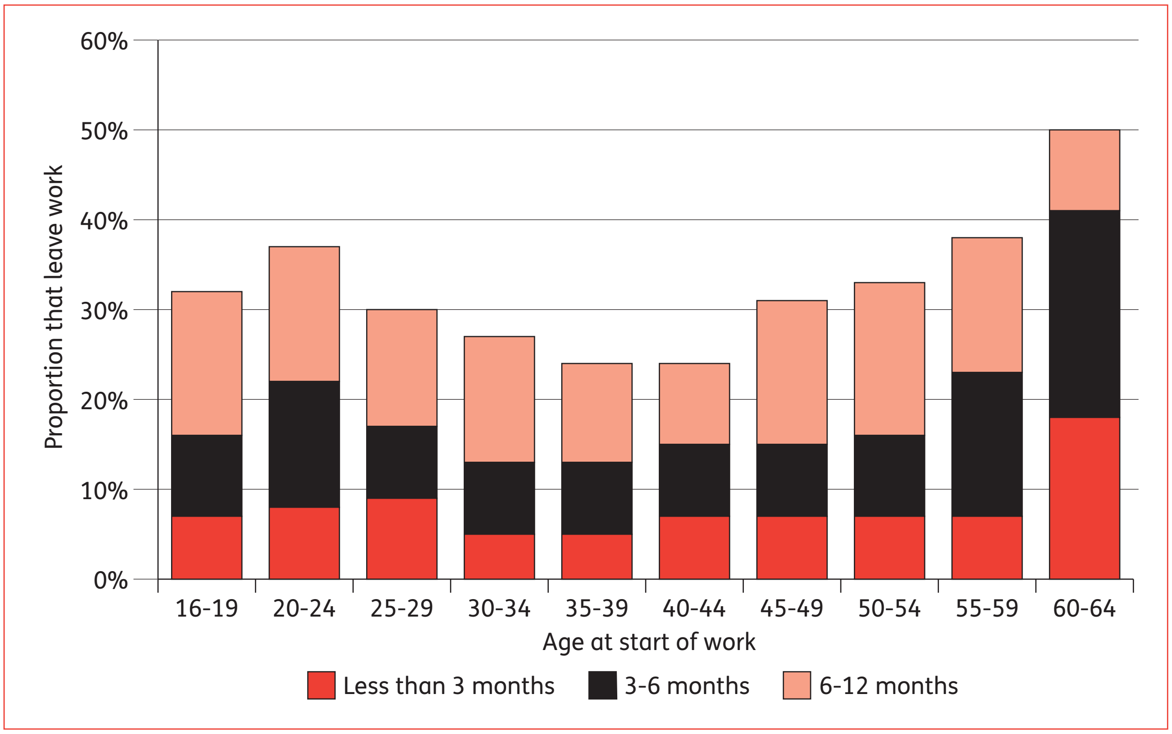
C.4.3 Introducing waiting periods prior to automatic enrolment

Employer churn analysis

The quarterly Labour Force Survey collects information on the length of the previous spell in employment for each respondent. From this, we can calculate how many spells in employment are less than three months, six months, and twelve months, and we can split this by age.

Chart C.4.3.1 shows the proportion of new starters leaving work before three months, six months, and 12 months by age. So, for example, nine per cent of those aged 20-24 who start working for a new employer will leave work before three months, compared to five per cent of those aged 30-34. Young people exhibit greater employer churn, whilst those starting a job aged 30-45 are likely to stay with that employer for longer. Far fewer people start a job aged 45 and over, but of those that do, they are more likely to leave their employer earlier than those in the below 45 age group.

Chart C.4.3.1: Proportion of new starters in each age group leaving work before three, six, and twelve months

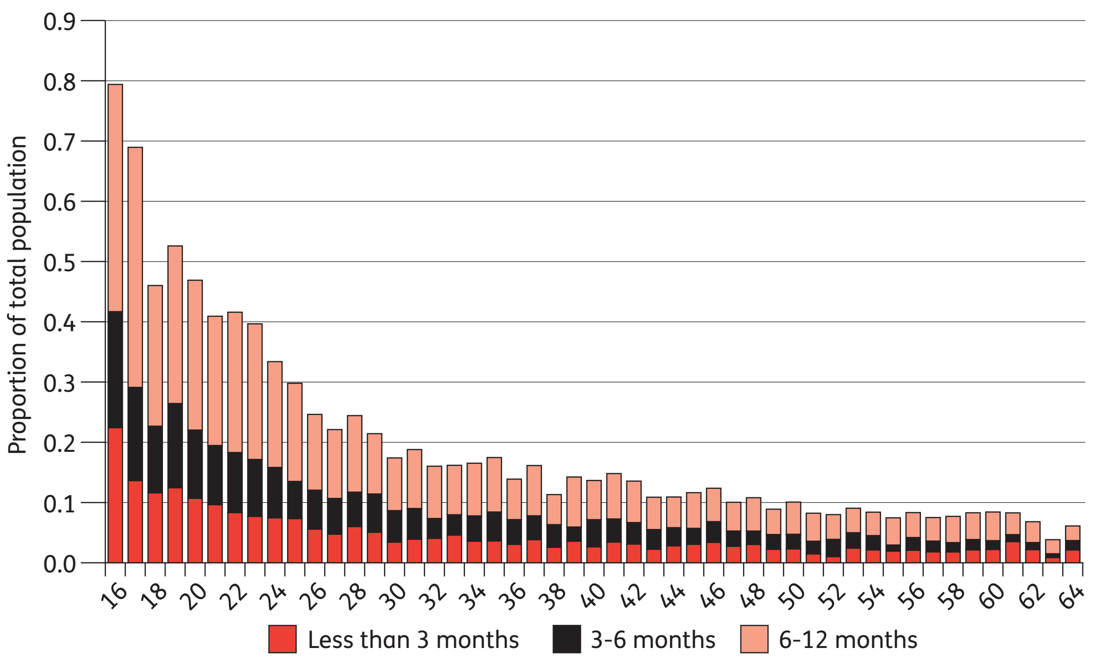


Source: Labour Force Survey, January-March 2008, Office for National Statistics.

Since the Labour Force Survey only gives information on the length of time in the previous job, first time jobholders will be excluded from the data. These jobholders will tend to be younger, and so they may be under represented in the analysis above.

Analysis using the Labour Force Survey supports the finding that *there is no identifiable age where the job churn rate significantly reduces* with a step change in the age of an individual. Chart C.4.3.2 shows the proportion of people in work for less than three months, six months and 12 months, out of the total employed population. The analysis shows how a waiting period would affect the population if implemented today. Far more younger employees have been in work for less than three and six months than older employees, and so a waiting period would have a disproportionate effect on younger employees.

Chart C.4.3.2 Proportion of people in current job for less than three months, six months, and twelve months, out of the total employed population



Source: Labour Force Survey, April-June 2007, Office for National Statistics.

C.4.4 Excluding smaller employers

Employer Transitions

Looking at the transition of employees across firm sizes, DWP analysis suggests that the majority of employees who work for smaller employers; one employee, 4 or fewer employees, and 19 or fewer employees **do not stay working for employers of the same size throughout their working lives**.

Analysis summarised in Table 5.4 show that the majority of employees working for smaller employers move into firms with more employees, and the overall proportion of employees who continue to work in the same size firm increased with firm size; employees who work for employers with only one employee were the least likely to stay working in the same size firm.[89]

89 The ONS cut the ASHE sample by 20 per cent in 2007 and 2008. This will have an adverse affect on the interpretation of longitudinal analysis, therefore these years have been excluded. The results are based on un-weighted data, and restricted to the main job. The results under-estimate the number of employees staying in smaller employers from one year to the next because the sampling frame slightly under-represented smaller firms, and because employer growth (workforce increasing from 4 to 5 employees) will be classified as a move between employers. Missing data due to an employee either leaving employment, or employer non-response will also lead to an under-estimate of the number of moves between employers over the 10 year period. The net effect is unknown. For this reason, great care should be taken when interpreting the results.

The analysis is based on individuals present in the survey for ten consecutive years, therefore it captures all moves. However, the restriction means sample sizes are relatively small and that the results should be treated with caution. Bearing this in mind, further analysis of this data shows that:

- *Working for an employer with one employee:* in any one year, around three per cent of employees who are eligible for automatic enrolment work for such an employer. DWP analysis suggests that 15 per cent of these employees continued to work for 10 consecutive years for an employer with one employee, whilst 85 per cent moved to larger employers at some stage in the ten year period
- *Working for an for an employer with four or fewer employees:* in any one year, around 13 per cent of employees who are eligible for automatic enrolment work for such an employer. DWP analysis suggests that 31 per cent of employees continue to work for 10 consecutive years for employers in this size band. Overall employees who worked for an employer with four or fewer employees in 1997 spent 4.1 years working for a larger employer at some stage in the ten year period
- *Working for an employer with 19 or fewer employees:* in any one year, around 32 per cent of employees who are eligible for automatic enrolment work for such an employer. DWP analysis suggests that, 51 per cent of employees continued to work for ten consecutive years for employers with 19 or fewer employers in this size band. Overall employees who worked for an employer with 19 or fewer employees in 1997 spent 2.7 years working for a larger employer at some stage over this ten year period

Overall, these results show that employees do not stay working for employers of the same size throughout their working lives. Excluding employees who are employed by smaller employers will therefore not exclude individuals permanently, but it is clear that the larger the employer, the larger the effect on potentially permanently excluding individuals from pensions saving.

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