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.**