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.