

# Private pension provision under changes to the automatic enrolment policy

# 7

## 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.

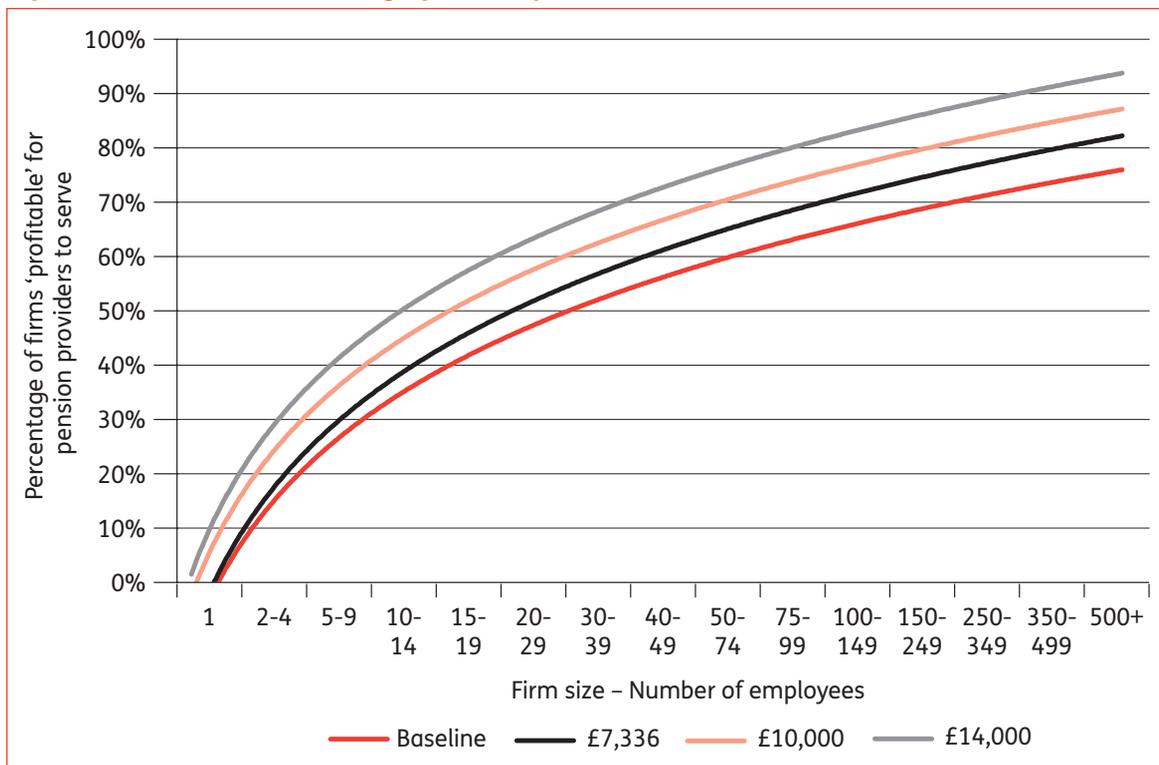
Increasing the earnings threshold for automatic enrolment, whilst still calculating pension contributions on earnings above £5,035, takes out some of the lowest earners who contribute the smallest amount, thereby increasing the average level of contribution. Industry stakeholder groups tended to support 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**

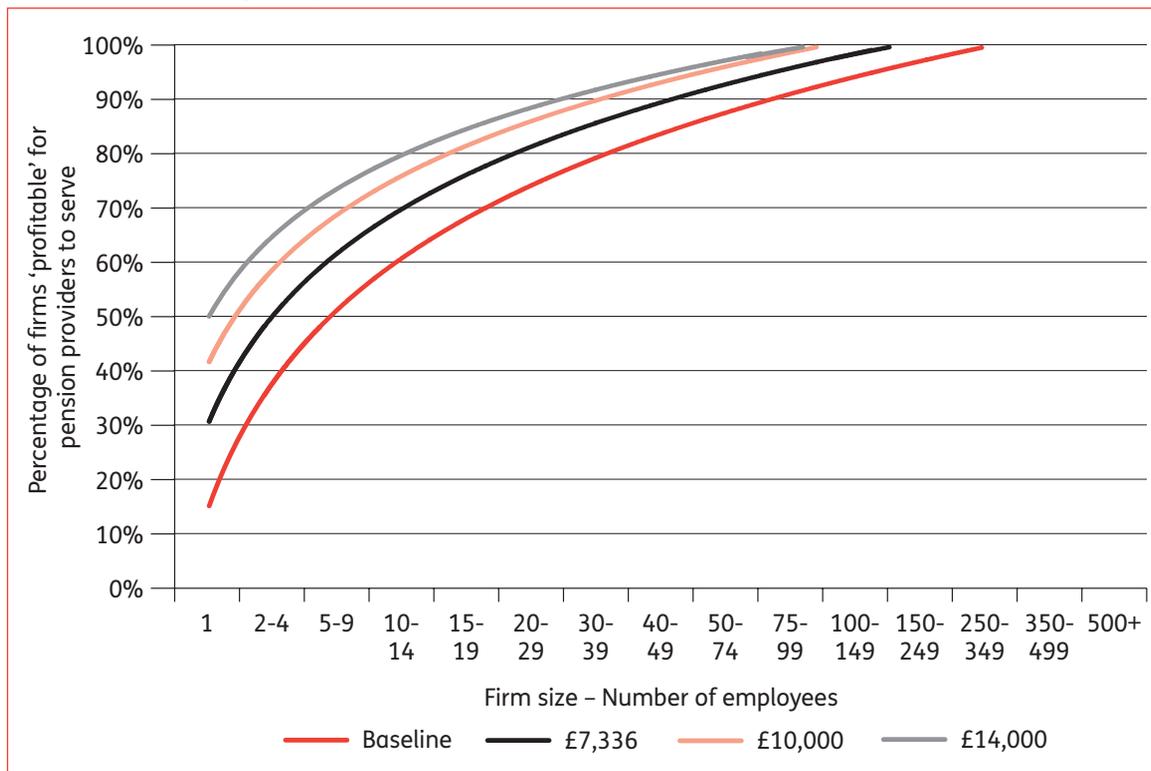


Source: Department for Work and Pensions modelling.

**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.

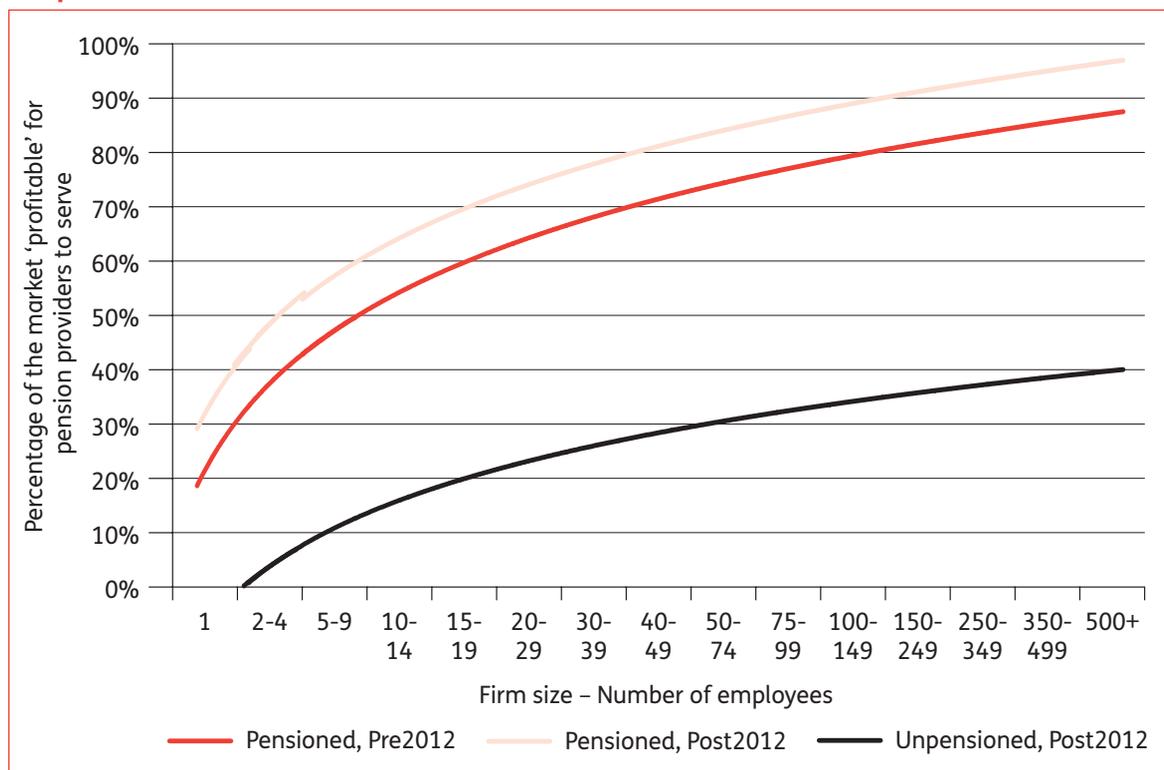
**7.2.4 Contribution levels: exclude micro employers**

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**

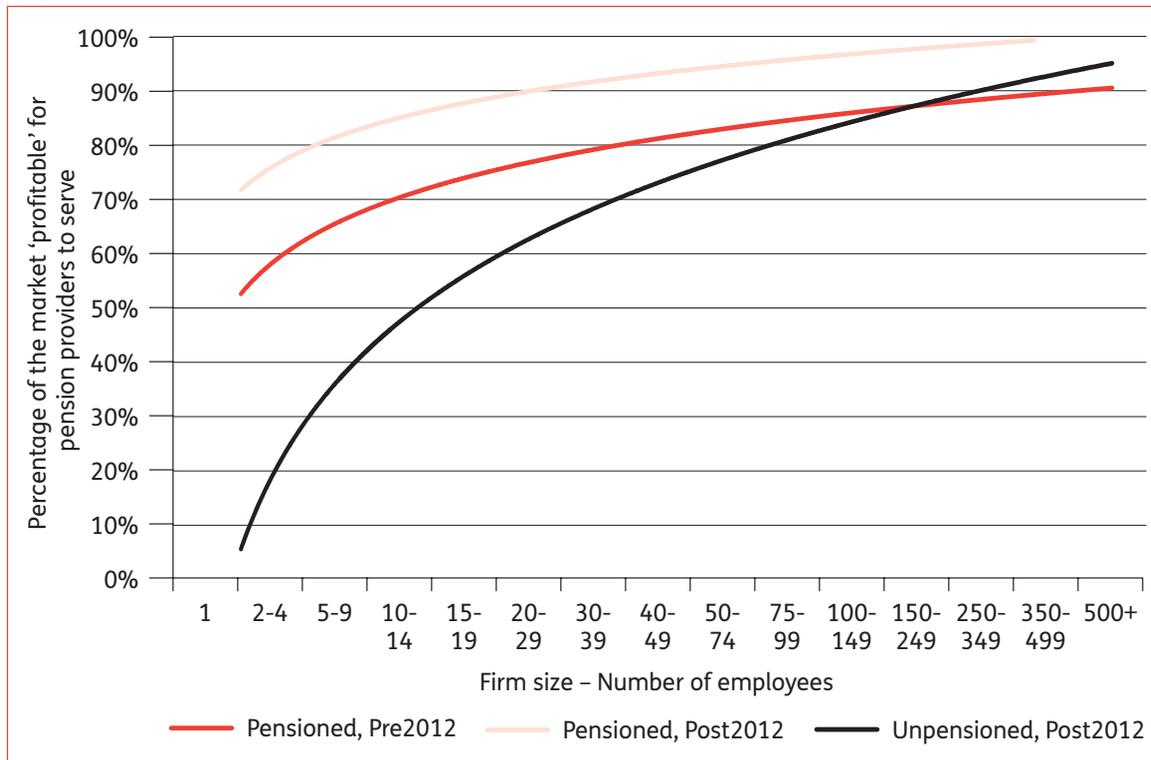


Source: Department for Work and Pensions modelling.

**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**

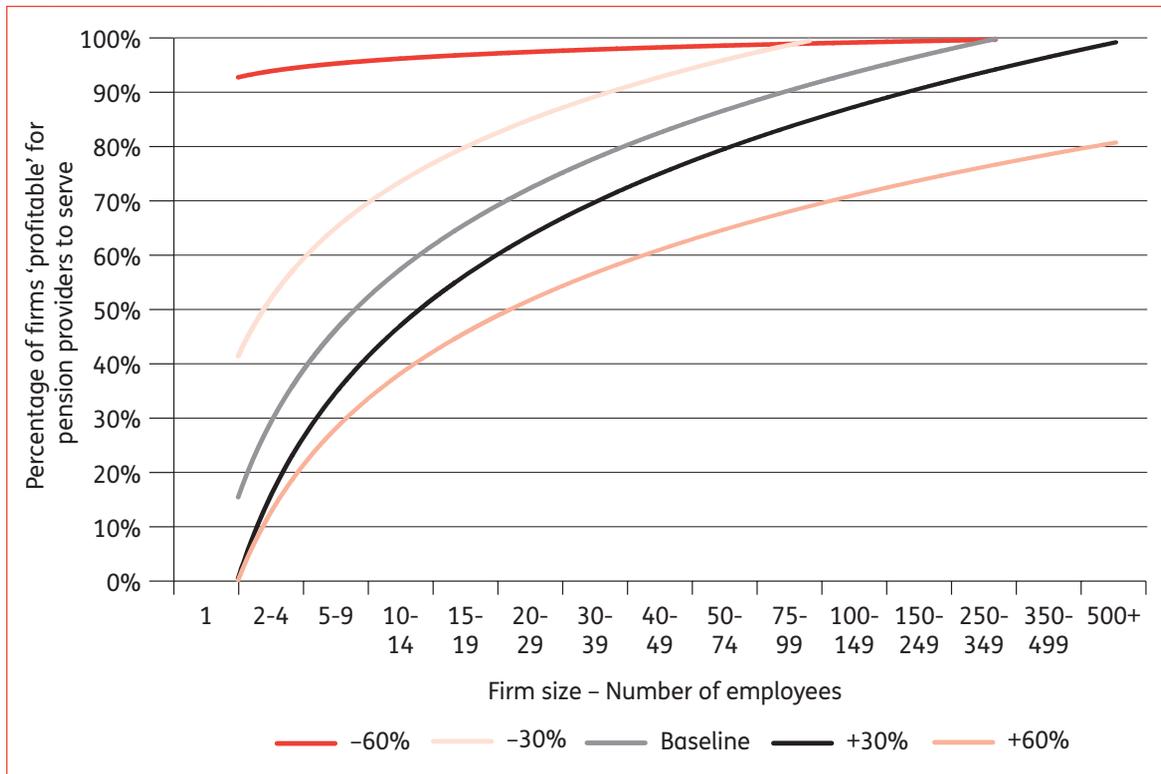


Source: Department for Work and Pensions modelling.

### 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.

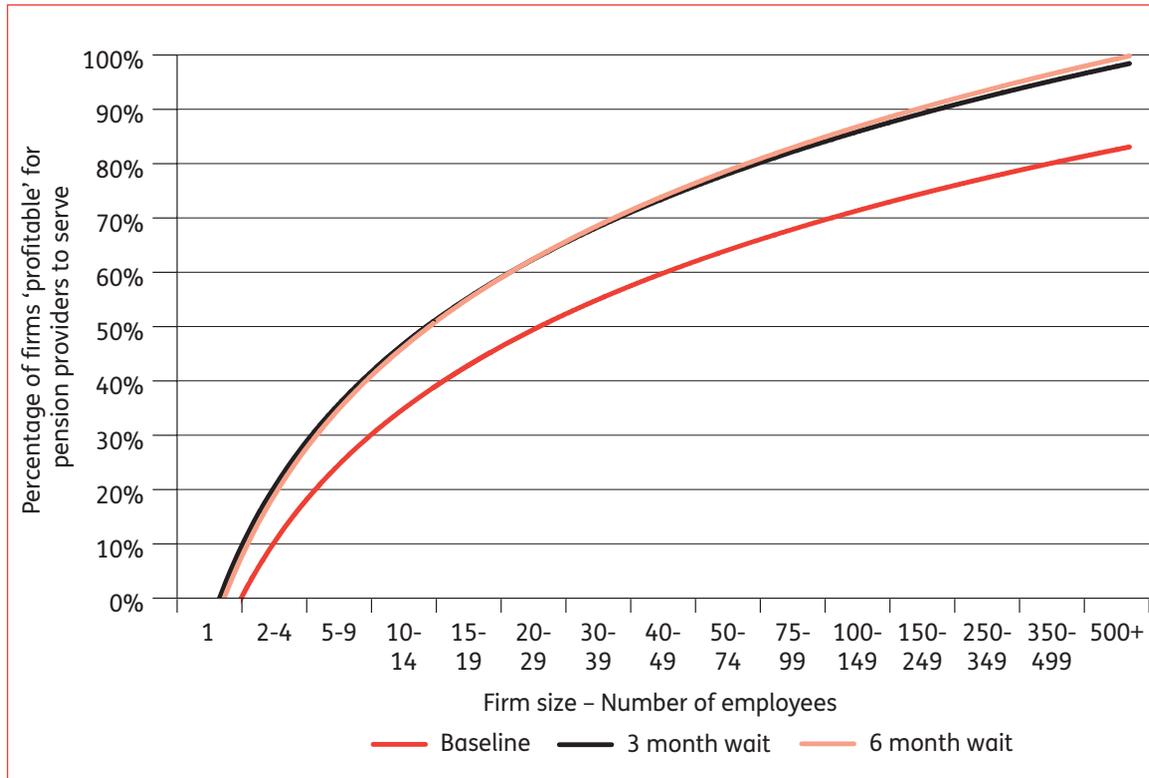
Under current policy, employers are required to automatically enrol eligible jobholders from day one of employment or when they become newly eligible. There are a group of people who move employment frequently and so will be repeatedly enrolled into pension saving for a short amount of time. Having a 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**

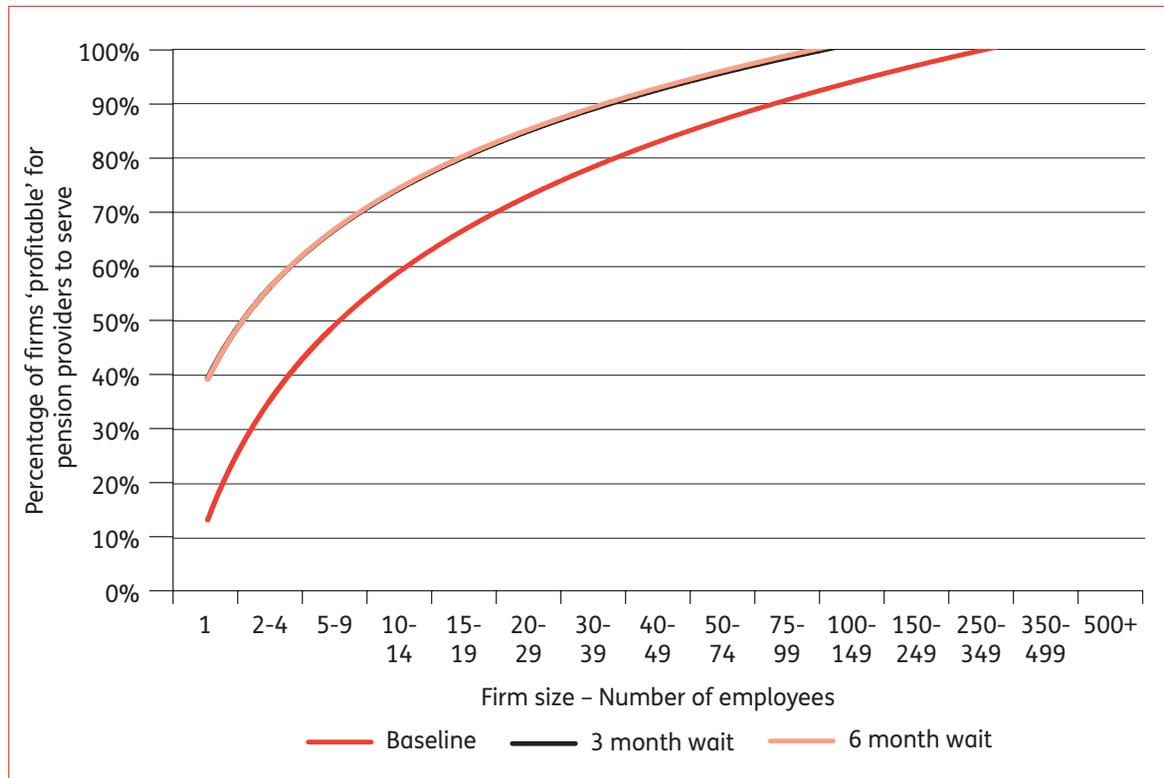


Source: Department for Work and Pensions modelling.

**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**

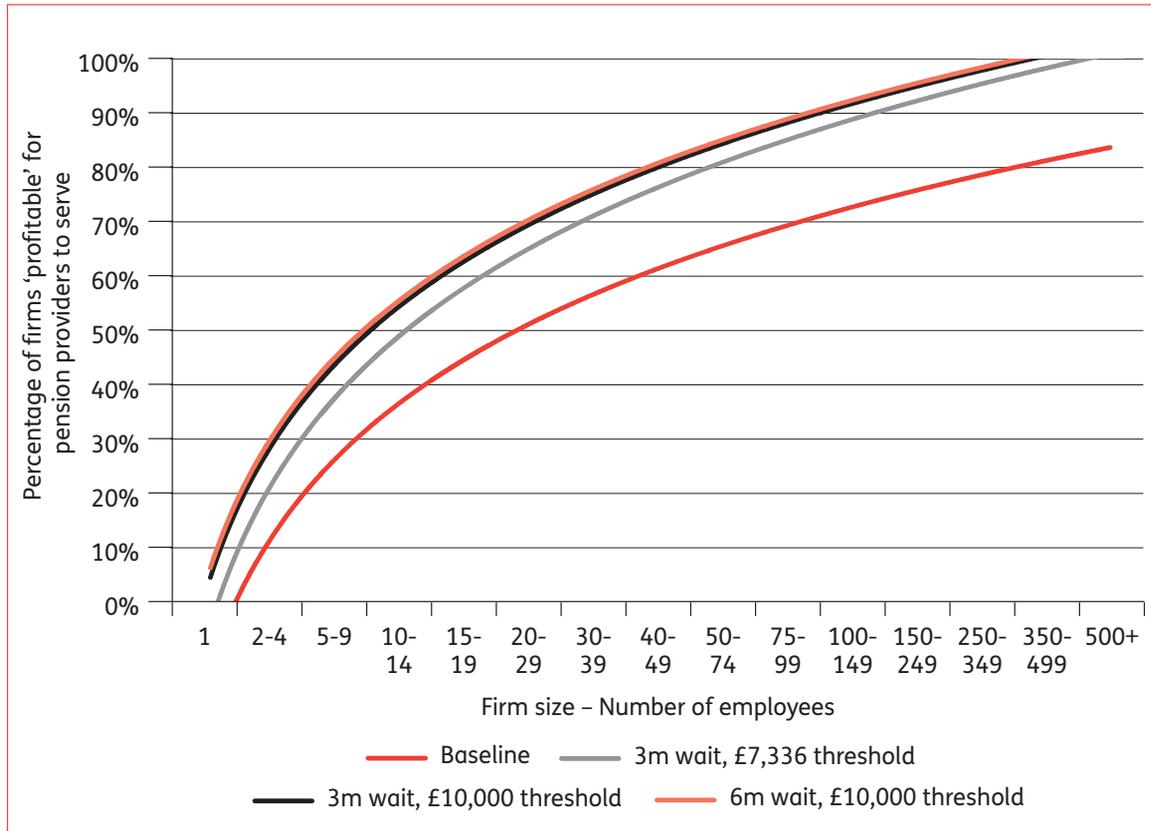
Under lower charge levels, there is clearly a need for NEST even if micro employers are excluded and a waiting period is introduced. If charges move up to the current Stakeholder Cap, Chart 7.7 illustrates that this position starts to look rather different. If only single-employee employers are excluded, 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.

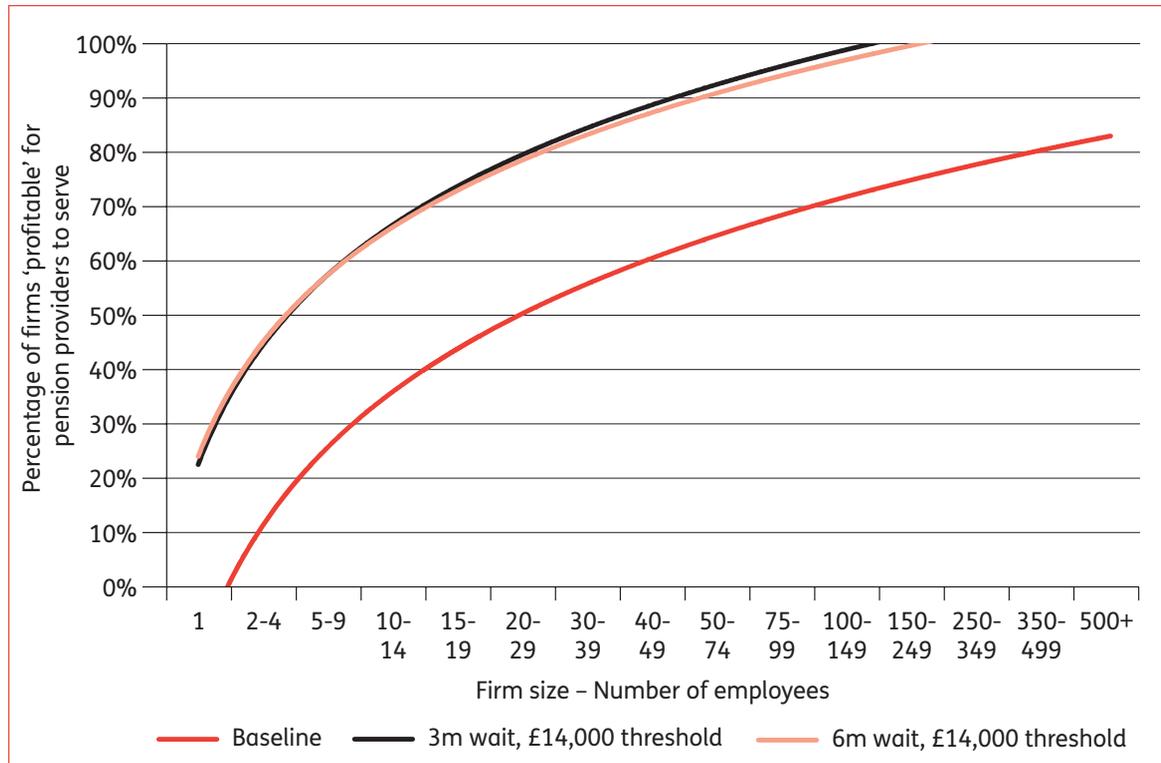
**Chart 7.8: Profitability with £7,336 and £10,000 earnings thresholds and waiting periods, under a three per cent contribution charge and 0.5 per cent AMC**



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**



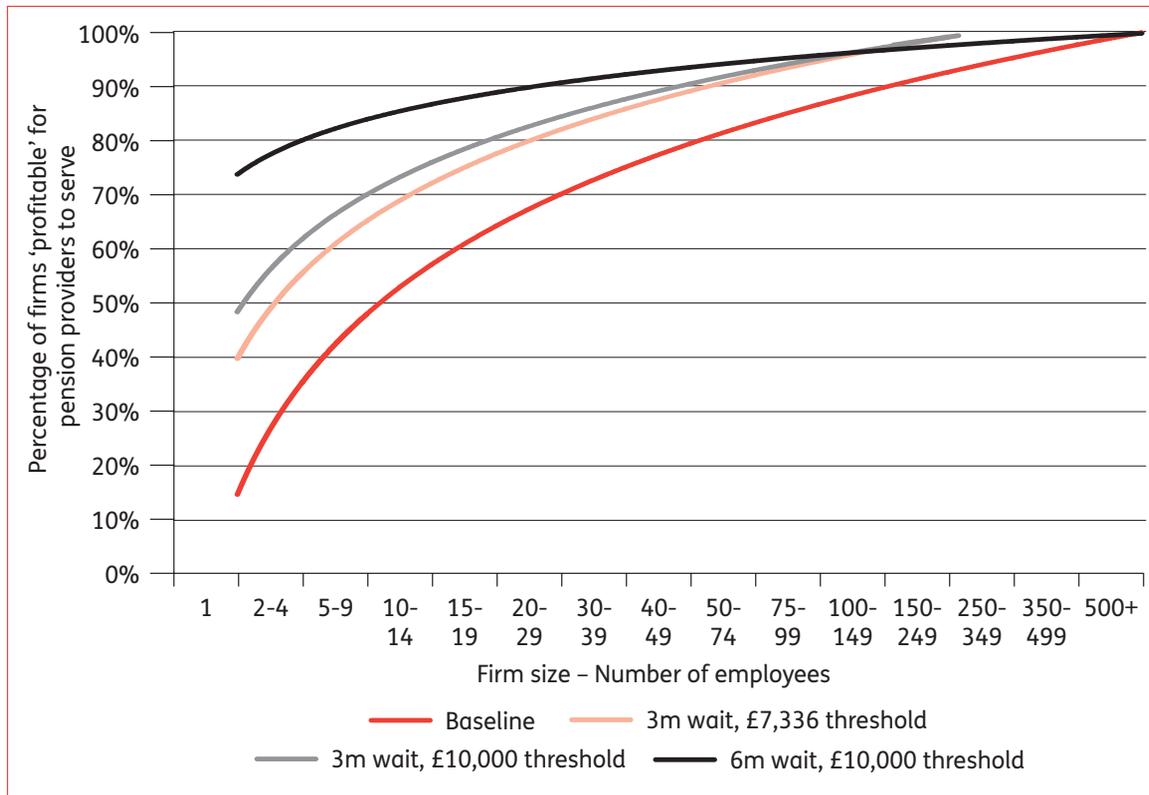
Source: Department for Work and Pensions modelling.

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.

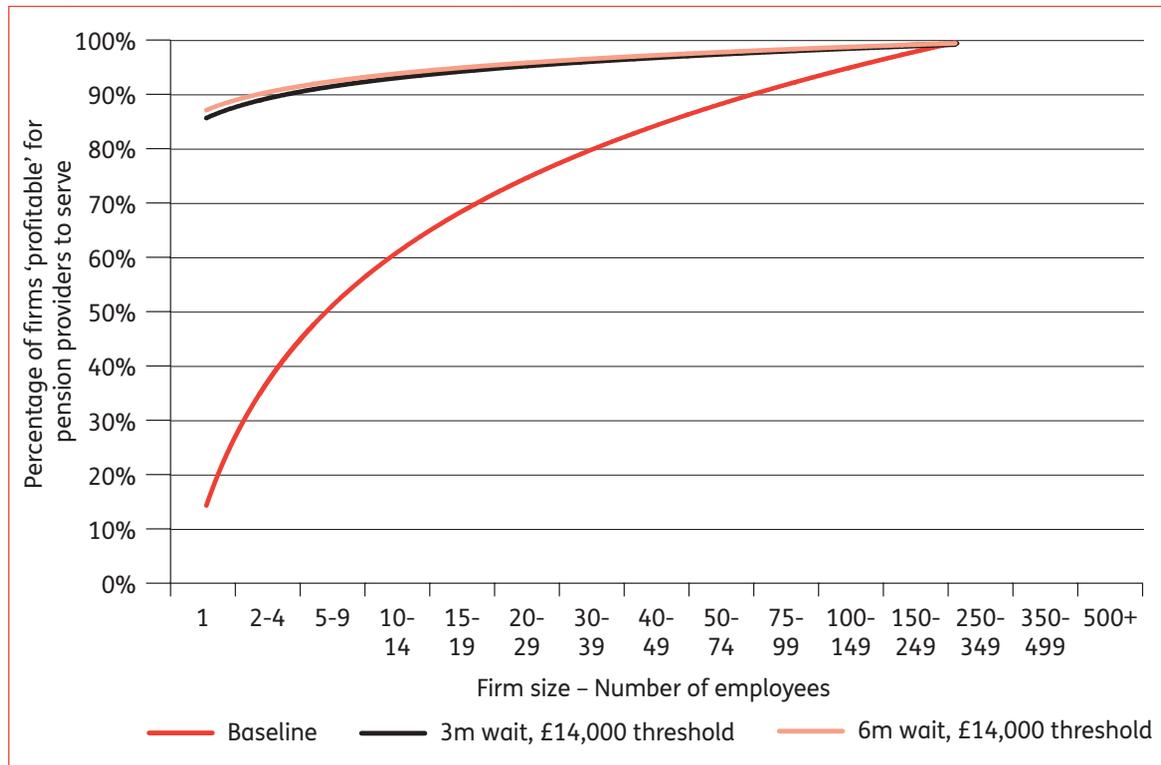
**Chart 7.10: Profitability with £7,336 and £10,000 earnings thresholds and waiting periods, under charges at the Stakeholder Charge Cap**



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**

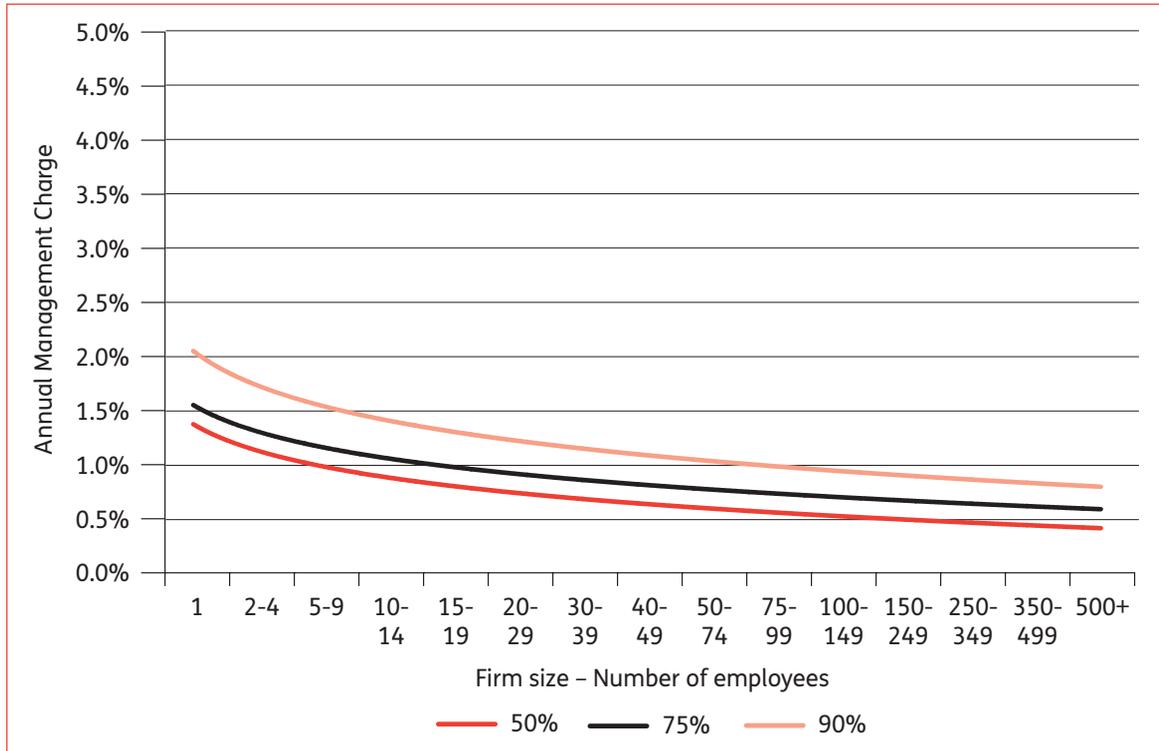
As we have seen, increasing the earnings threshold to £14,000, introducing a three month waiting period and allowing charge levels up to the Stakeholder Charge Cap gets us most of the way to making the whole of the employer market profitable for pension providers to serve. Excluding single-person employers 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.