Trade-offs and recommendations 8

Summary

In this chapter, we bring together all the analysis from earlier chapters to consider the most appropriate overall policy package to support the introduction of automatic enrolment.

First, we draw conclusions on the coverage for automatic enrolment that strikes the best balance for individuals; we consider the regulatory burden on the smallest employers and how this can best be mitigated; and we assess a range of further deregulatory measures.

We then bring these conclusions together and assess the impact of the overall package of change they represent, considering the impact against the assessment criteria set out in our terms of reference.

Finally, we compare this analysis with the impact of some alternative scenarios to demonstrate the trade-offs between different possible approaches.

This leads to our final package of recommendations:

- **The earnings threshold at which an individual is automatically enrolled into a workplace pension is increased and aligned with the income tax personal allowance and the threshold at which pension contributions become payable is aligned with the National Insurance primary threshold. Workers can opt in to saving and receive an employer contribution if they earn between these two thresholds.**
- **There should no changes to age thresholds.**
- **The automatic enrolment duties should apply to all employers regardless of size as now.**

- **Communications to micro employers from The Pensions Regulator should flag as strongly as possible that the design of NEST specifically takes account of their needs, and should support easy access to NEST.**
- **DWP should look to provide maximum possible comfort to employers that they will not be held liable for their scheme choice, particularly if they opt for NEST or a stakeholder scheme to fulfil their new duties.**
- **There should be a simpler system by which employers can certify that their defined contribution pension scheme meets the required contribution levels.**
- **There should be an optional "waiting period" of up to three months before an employee needs to be automatically enrolled into a workplace pension. Workers can, however, opt in during the waiting period.**
- **The largest employers, who are scheduled to be brought into the reforms in October and November 2012 should be allowed to automatically enrol ahead of the planned start date of October 2012, and as early as July 2012, if they wish to do so.**
- **Employers should be given flexibility around the date they re-enrol employees who have previously opted out by allowing a six month window for this activity to take place.**
- **NEST should go ahead as planned to support successful implementation of automatic enrolment.**
- **Legislation should make clear that NEST's "contribution cap" will be removed in 2017.**
- **Government and regulators should review as a matter of some urgency how to ensure that it is more straightforward for people to move their pension pot with them as they move employer, so that, by the time of the 2017 review, the more general issue of pension transfers has been addressed and NEST is able to receive transfers in and pay transfers out.**
- **Government should review as a matter of some urgency the scope for regulatory arbitrage between the trust and contract based regulatory environments.**
- **Government should continue with work to review whether the existing regulatory regime for the provision of defined contribution workplace pensions remains appropriate in the post automatic enrolment world.**
- **Government should ensure there are effective communications to individuals, employers (and especially smaller employers) and the pension industry in the lead up to and during the implementation of the reforms.**

We believe that these recommendations, taken together as a package, represent a fair balance between employees, employers (both small and large) and the taxpayer. They represent a realistic updating of the original Pensions Commission proposals in the light of the current economic position, while supporting the speedy implementation of these important reforms.

8.1 Introduction

Chapters 5, 6 and 7 work through the effects of a number of different options in detail. In this Chapter, we evaluate the key options against our objectives to build the most appropriate package of changes to achieve the aims of the review. We then look at different possible approaches and compare three core models against the status quo policy.

In undertaking this review we were asked to consider whether the proposed scope of automatic enrolment strikes the right balance between costs and benefits for individuals and employers and, in the light of this, whether NEST is the most effective means of delivering private pension reform. In recommending any changes to the current scope of automatic enrolment there are two core issues:

- For most people, pension saving will be beneficial. However, there are some low earners who would achieve little or no welfare benefit in "consumption smoothing" over their lifetime. We need to ensure that the scope of automatic enrolment correctly balances the risk of being over-inclusive against the risk of excluding some people for whom it would genuinely pay to save.
- Whether the burdens on employers and, particularly smaller employers, are proportionate and whether greater regulatory simplicity can be achieved without jeopardising the aims of the reforms.

In evaluating the best options for delivering improvements, there are inherent trade-offs between the benefits for individuals and burdens on employers. The core objective of the reforms has always been to get more people into saving and reduce pensioner poverty in the long term. It is important that we consider how far any set of options might start to erode this aim. In addition, key considerations are maintaining the consensus behind the reforms, operational implications of any change and the importance of meeting the current target date of October 2012 for implementation. Looking at the combined options, we need to find the right balance between deliverability, employer burdens and maximising savings, whilst bearing in mind the other key concerns we have been asked to consider.

8.2 Ensuring the 'right' individuals are automatically enrolled

Our key concern here is ensuring that the right balance of risk is achieved between automatically enrolling an individual into pension savings who may not benefit from saving (relying on them to opt out) and not automatically enrolling an individual who should be saving (relying on them to opt in). Chapters 2 and 5 set out the arguments in detail.

8.2.1 Earnings thresholds

In synthesising the evidence (set out in Chapter 5), we concluded that there are two broad options:

- To raise the annual earnings threshold to around £14,000, excluding persistent low earners (and all those working full-time on national minimum wage) who have most risk of achieving a high replacement ratio without saving, but also excluding many employees who may gain from saving, either due to their current circumstances (e.g. low earners in higher-income joint households) or due to later changes in their hours of work and/or earnings.
- To leave the earnings threshold relatively low (£5,000 - £8,000), ensuring that all those likely to gain from savings are automatically enrolled, with the risk that some people who are automatically enrolled and then remain in pension savings may not see an overall gain in terms of social welfare from consumption smoothing (albeit they do retain the right to opt out).

We have been deterred from recommending a threshold of £14,000 by the risk of excluding many people who would benefit from saving. Many low earners will go on to earn more throughout their lives and may still benefit from building up persistent pension savings. Many individuals with low earnings are part of wider households with higher total incomes. 69 per cent of the 2.9m people excluded would be women, who tend to fare less well in retirement than men. Large numbers of those who would be affected by such an exclusion also have a substantial incentive to save as pension contributions do not count in assessing eligibility for working tax credit.

In keeping the threshold relatively low, we feel that there are nevertheless benefits of increasing the threshold away from the current level and separating the eligibility threshold from the bottom of the contributions band. There are considerable benefits in aligning the eligibility threshold with the personal income tax allowance and the bottom of the contribution band to the equivalent of the National Insurance primary threshold. We would envisage that, under this arrangement, any individual who is automatically enrolled continues to pay contributions until their earnings drop below the level of the bottom of the contributions band (unless they opt out).

Pros

- Excludes the very lowest paid, who are not income tax payers.
- Separates the eligibility threshold from the contributions threshold and effectively creates a de minimus for contributions. We feel this is important for the credibility of the reforms, since it avoids situations whereby individuals are making very small pension contributions. For employers this reduces the administrative costs relative to the benefits for employees.
- Aligning the threshold with an existing level (for paying tax) improves simplicity for everyone, and reduces the regulatory burden on employers.
- This arrangement provides a buffer for individuals who would otherwise repeatedly move in and out of pensions saving because their earnings fluctuated slightly, reducing the administrative burden for employers and ensuring greater persistency of saving.

Cons

- Maintaining a relatively low threshold runs the risk of automatically enrolling individuals for whom it might not pay to save (see Chapters 2 and 5 for a detailed discussion).

We are reasonably content that the opt out process is sufficiently simple to mitigate the risk of very low earners ending up saving inappropriately.

Recommendation:
The annual earnings threshold be aligned with the threshold for paying tax, (£7,336 in 2010/11 terms). The lower limit for the band of contribution should be aligned with National Insurance Contribution thresholds. Our presumption is that the thresholds would remain aligned with the tax allowance and National Insurance primary threshold, unless future action by Government resulted in a fundamental change in their purpose or in the relationship between them. In particular, we consider aligning the threshold at which a jobholder is automatically enrolled with the income tax threshold to be consistent with the Government's stated aspiration to increase the tax thresholds to £10,000 in nominal terms over the course of this Parliament. Workers can opt in to saving and receive an employer contribution if they earn between the two thresholds.

8.2.2 Age thresholds

Some stakeholders have suggested that the lower age threshold for automatic enrolment should be reduced, either to encourage saving from a younger age, or to align with the age threshold for entitlement to the national minimum wage. We feel that the lower threshold is a balance between establishing patterns of saving earlier and avoiding automatically enrolling very young people with high labour market churn (e.g. those working in temporary jobs whilst in tertiary education). We feel that the current threshold at age 22 strikes the right balance between these aims.

We are more concerned about the upper age limit, which could see older workers saving for relatively little benefit, particularly in the early years of the regime whilst contributions are phased in. Chapters 2 and 5 provide a detailed analysis of replacement rates for individuals who start to save at different ages. There was some limited support among employer and industry stakeholders for reducing the age limit to 55 (from state pension age). We discussed the impacts of this option in detail in Chapter 5, and our primary arguments can be summarised as:

Pros

- Removes older employees who will have less time to build up savings and may lose out through interaction with means tested benefits.

Cons

- Many older savers will still benefit from saving, including those with existing savings, which will be topped up by automatic enrolment contributions, and those with no previous savings, who may be able to trivially commute their contributions at retirement.

- We cannot assume that older workers would necessarily retire at State Pension age; excluding older workers could also conflict with the Government's current extended working lives agenda.

On balance, we feel that even small savings are still likely to be worthwhile for older savers and the upper age limit should not be reduced. At the same time, we would not consider increasing the upper limit beyond the State Pension age. We feel that this strikes the right balance between ensuring people have access to pension saving during their normal working lives and avoiding automatically enrolling people for whom saving is no longer the right option.

Recommendation:
The age band for eligibility remains at age 22 to State Pension age

8.3 Options to reduce burdens on employers

We are concerned about the regulatory burden of the reforms on employers as a result of the proposed automatic enrolment process and the risk to the credibility of the reforms that this brings. Our concerns include:

- Concern that the impact of the requirement to automatically enrol employees from day one, together with no facility for an employee to opt out before being enrolled, might lead to unwieldy processes and an unnecessary and disproportionate regulatory burden. This could damage the credibility of the reforms.
- Concern that assessing minimum levels of pension contribution as a percentage of a band of total earnings above an earning threshold is different to the way many employers currently assess contributions (often a percentage of "basic pay" from the first pound earned). This could make it burdensome for employers to assess whether their scheme meets the minimum level of contributions required by the new duties.
- A lack of flexibility around the dates employers are required to automatically enrol or re-enrol their employees into pension saving.
- Difficulties for employers, particularly smaller employers, in determining a suitable scheme to fulfil their new duties.

As discussed in Chapter 3, we are particularly concerned about the impact of the administrative burden on smaller employers because:

- There is a potentially high burden on the smallest employers.
- While the vast majority of employers are small employers, they employ a relatively small proportion of total employees. This raises the question of whether the regulatory burden, in conjunction with the costs of ensuring compliance, is proportionate to the benefits generated.

In Chapters 5 and 6 we have therefore explored a range of ways of reducing administrative burdens on business and smaller employers in particular. Here we summarise our key arguments and recommendations for each option.

8.3.1 Excluding micro employers

We have looked at the rationale and impacts of excluding different sizes of employers from the scope of the reforms, considering the cost savings to employers against lost benefits to employees.

Pros

- The smallest employers face a potentially high regulatory burden as a result of the reforms. Very few have any experience of administering pensions and most will not have dedicated HR functions to help with this. Removing micro employers from scope lifts this burden from them.
- We consider that micro employers present the highest risk to the compliance regime; removing these employers from scope would greatly reduce this risk.
- The cost of the regulatory regime would also be much reduced by excluding micro employers.
- The smallest employers employ a relatively small proportion of the workforce and therefore the administration costs generate proportionately less overall pension contributions.
- Many of those employing a single person are individuals employing carers and nannies. These individuals may be poorly placed to take on new costs and burdens.

Cons

- 1.5 million people would be excluded from automatic enrolment on a basis not related to the value to themselves of pension saving.
- There are practical concerns about the operation of an employer size cut-off, particularly in identifying at the margin which employers fall each side of the cut-off, and in how to treat employers who increase or decrease their workforce. For example, if an employer shrunk to below the threshold, a situation could arise whereby comparable employees within a single firm would have different pension rights based on when they joined the firm.
- There could be a strong disincentive against business growth; since the marginal contribution costs of hiring a fifth employee would quadruple if micro employers are excluded from automatic enrolment.
- Including all employers ensures a competitive level playing field, a point which some stakeholders have stressed.
- There would be a significant gender disparity among those affected, 71 per cent of the excluded group would be men.

On balance, we are persuaded that smaller employers should remain within the scope of the automatic enrolment duties. Nevertheless, we remain concerned about the burdens on small employers and are only content to recommend they remain within scope if other deregulatory options are implemented to ease their administrative burden.

It should be as straightforward as possible for small and micro employers to select an appropriate scheme, without a significant burden of choice. Consequently, we have looked at how to make it as easy as possible for micro employers to access NEST, given that the majority of micro employers are likely to use NEST.

8.3.2 Making NEST easily accessible for micro employers

There is a strong case for ensuring that micro employers can avoid the costs and potential confusion associated with looking for a scheme on the open market. Some of the smallest employers may be unable to find a provider able to offer them a suitable scheme at an appropriate charge level, so the choice for many could be effectively limited to NEST.

Whilst we do not think it appropriate that micro employers are simply defaulted into NEST, we consider that a sensible and effective approach would be for correspondence to micro employers from The Pensions Regulator to make clear that the design of NEST specifically takes account of their needs, and should support easy access to NEST.

NEST is specifically designed to meet the needs of smaller employers; that the scheme has a public service obligation to serve all employers who want to use it at a fixed charge level; and to provide contact details so that employers can access NEST easily. We recommend that Government should go as far as it can in making it clear to micro employers that NEST is an easy and appropriate choice for them.

8.3.3 Providing a ‘safe harbour’ for employers

Employers, and particularly smaller employers, have expressed concern that they might be held liable for the consequence of their scheme choice should the selected scheme turn out to perform badly.

We understand that the risk of an employer being found liable for automatically enrolling an employee into a scheme which underperforms is low and that the risk of employer liability for the provision of information to individuals is minimal. However, the issue for employers is not just the level of legal risk, but uncertainty about their potential legal liabilities.

We recommend, therefore, that government explores whether there are ways of providing legal assurances to employers when choosing a scheme to meet their automatic enrolment duties.

Recommendations:

- All employers remain within scope for automatic enrolment.
- NEST is strongly flagged to micro employers by The Pensions Regulator.
- DWP should look to provide maximum possible comfort to employers that they will not be held liable for their scheme choice, particularly if they opt for NEST or a stakeholder scheme to fulfil their new duties.

8.4 Further deregulatory options for reducing burdens on employers

In addition to looking specifically at regulatory easements for smaller employers, we have looked at a range of options to increase simplicity for all employers (Chapter 6), including a discussion of a universal waiting period (see Chapter 5 for detail). We take each of these options in turn and summarise the key issues for each, along with our recommendations.

8.4.1 Waiting periods

There is a range of arguments for proposing a waiting period as a way of reducing regulatory burdens:

- Removing high churn workers who represent a high administrative cost to employers for relatively small contribution gains.
- Allowing employers more time to complete all the processes involved in automatic enrolment.
- Allowing employees more time to decide whether they want to stay in the scheme or not, especially those on weekly pay.

Stakeholders have also linked a waiting period to the option of allowing employees to opt out before they are put into a pension scheme, citing this as a further way to reduce administrative burden. We have considered this option separately in Chapter 6. However, on balance we are not minded to recommend this option.

If we want a waiting period primarily to remove the burden of processing high-churn employees, this would lead us to a reasonably long waiting period. By contrast, if we are simply looking for an administrative easement to allow employers more time to complete automatic enrolment processes, then allowing an extra month or so flexibility may be sufficient. We feel that all of these reasons are important, and therefore examined a waiting period of up to three months. We feel that the most crucial points to consider are:

Pros

- A waiting period prevents employers from having to enrol and then un-enrol temporary workers. We feel that this nugatory work could otherwise undermine the credibility of the reforms. Out of around two million enrolments per year in steady state, 190,000 enrolments are for employees who leave within three months.[84]
- Allowing employers the flexibility to select an automatic enrolment date any time within a three month period enables them to align this activity with their existing payroll cycles.
- It also reduces the likelihood of the employee failing to return the opt out form before contributions are deducted, reducing the risk that refunds will have to be paid.
- A waiting period may mitigate the risk of employers choosing to use trust-based schemes to make use of rules for short-service refunds, which would result in poorer outcomes for savers.

84 Source: Labour Force Survey 2007. Figures based on people in the target group who had started a job within the previous 12 months.

- Employer and industry representatives have universally called for a waiting period as a means of easing regulatory burden.

Cons

- Consumer and employee representatives are against a waiting period as it risks excluding high churn workers from pension saving.
- On any particular day, 400,000 individuals would not be eligible for automatic enrolment due to the waiting period. Some employees may never access pension saving, if they work on short term contracts for the majority of their career. Even for those who are eventually enrolled, the average saver could lose up to three years worth of pension contributions over their lifetime.
- Replacing the easement only for "good quality" schemes with a universal waiting period, risks undermining the current benchmark for a "good scheme", with an associated risk of levelling down of existing provision.

On balance we feel that a waiting period strikes a reasonable balance between regulatory easement, particularly for smaller employers, and the risks to individuals' savings. However, in recognition of the impact on some individuals, we recommend that eligible employees be allowed to opt in to the scheme during the waiting period.

We discussed whether to couple a universal waiting period with a longer postponement option for higher quality schemes to give employers with such schemes an additional easement. This may help to maintain a higher benchmark for defining good quality schemes.

Overall, however, we concluded that the universal three month waiting period is sufficient to resolve the issues of employer churn.

Recommendation:
Employers be allowed to use a waiting period of up to three months before automatic enrolment; individuals are allowed to opt in to the scheme during that time. This replaces the existing postponement arrangement for employers using higher quality schemes.

8.4.2 Providing flexibility around when employers have to act

Stakeholders have called for greater flexibility around the timing of staging and re-enrolment. We have explored a number of ways of providing further flexibility, summarised below. Chapter 6 gives greater detail of the rationale and impacts of each option.

Flexibility around staging

We looked at whether it would be possible to give employers total flexibility around their staging date to align activities with their business cycles. However, we are convinced that this would not be operationally viable, since it could result in large numbers of employers selecting September 2016 as their staging date, substantially exceeding operational capacity and risking unstable implementation of the reforms. This could also result in members missing out on up to four years of contributions. We are therefore not recommending this option.

We then looked at allowing employers to select any day within a month as their staging date, allowing them to align this date with their existing payroll and thus avoid part-period calculations of contributions. Other things being equal, we were minded to recommend this option, but our recommendation of a waiting period of up to three months already allows this flexibility.

Stakeholders representing the interests of employment agencies suggested that all such agencies be staged in as a single group to mitigate competition effects. We have not seen convincing evidence that the competition problems are significantly greater for employment agencies than for other labour intensive businesses, but, more importantly, we do not think this would be operationally possible primarily because these employers are not readily identifiable but also because it would mean staging 1.3 million individuals on a single day. We are therefore not recommending this option.

Most employers will have the flexibility to bring their staging date forward if they wish to do so. There is, however, currently no facility to automatically enrol before the October 2012 start date for the reforms, which means the largest employers (with 50,000 or more employees) who are due to be brought into the reforms on 1 October 2012 and 1 November 2012 have no or only very limited flexibility around their staging date. We recommend that these employers be allowed to automatically enrol as early as 1 July 2012 if they wish to do so.

Flexibility around re-enrolment

We also looked at whether to remove or delay the re-enrolment requirement. We are convinced that re-enrolment serves as a useful trigger to prompt employees to reconsider their savings arrangements. Further, re-enrolment is helpful in preventing the 'erosion of compliance' that may occur once the staging date has passed, reminding employers of their continued duties. We feel that extending re-enrolment to five year cycles would potentially weaken the compliance regime and result in individuals missing out on saving. For these reasons, we are not recommending the removal or delay of re-enrolment.

We have, however, looked at providing employers with greater flexibility around the timing of re-enrolment and concluded that it is appropriate to allow a window of three months before and after the scheduled re-enrolment date to enable the employer greater freedom to select a time of year that suits their business.

Recommendations:

- Large employers due to be staged in October and November 2012 are able to choose to act early, up to July 2012.
- Employers have three months flexibility either side of their scheduled re-enrolment date.

8.4.3 Simplifying processes for employers

As set out in Chapter 3, automatic enrolment will require employers to undertake a series of tasks to comply with the duties, some of which will be new to them. We have therefore looked carefully in Chapter 6 at ways of simplifying these processes, to ease the administrative burden for employers.

Allowing individuals to opt out before automatic enrolment

Stakeholders have argued that not allowing opt out before automatic enrolment requires both the employer and employee to go through a process that could have been avoided in situations where the employee already knows they do not want to save. This will result in the employer taking contributions which then have to be refunded and therefore creates nugatory work for the employer.

We therefore considered whether to allow employees to opt out during the waiting period (or in the run up to re-enrolment). We are attracted to this option as a deregulatory improvement, but there are a number of downsides to consider. It would represent a move away from automatic enrolment and the behavioural economic benefits of requiring an individual to become a member of a scheme before they can opt out. We have also been advised by DWP officials that it would require a significant re-working of the Pensions Act 2008, which is based entirely on the premise that enrolment comes before opt out. This rewrite of the Act would mean employers, the pensions industry and payroll providers would not have sufficient clarity to prepare for the reforms in time for the October 2012 implementation. On balance, we feel that the various problems with this option outweigh the deregulatory benefits and we therefore do not recommend this option.

Simplifying the opt out process

We have also looked at whether it would be possible to simplify processes for individuals to ensure that those for whom it is not appropriate to save find it easy to opt out. For example, we might broaden the source of the opt out form, simplify its contents and make it explicitly available from day one. However, we must balance simplicity against the potential risks associated with these changes, such as greater risk of coercion by employers, or the risk that individuals may sign the form immediately if it is available more easily, without really considering their options.

We feel that the existing opt out processes are sufficiently simple that any further gains would be marginal and outweighed by the risks associated with the posited changes. We are therefore not recommending any change.

Calculating contributions on basic pay from £1

The definition of ‘qualifying earnings’ differs from the pay definitions that most employers use to calculate pension contributions. We have considered whether to change the definition of qualifying earnings to a simpler one using basic pay calculated from pound one. However, we are persuaded that the additional employer and exchequer costs are likely to make this option untenable. Further, we consider, and stakeholders largely agree, that a simple “certification model” (see below) would address concerns about the qualifying earnings definition. We are therefore not recommending this change.

Simplifying certification of eligible schemes
We have considered how to help those employers with existing good defined contribution schemes to determine that their scheme meets the qualifying criteria in the Pensions Act through a self certification model. It is critical to get this model right and make it as simple as possible. Without this easement, automatic enrolment poses real challenges for employers who have existing good schemes, but who calculate pension contributions on a definition of pay different from qualifying earnings. We do not want to see these employers discontinue their good pension provision, or level down contributions, to cover the costs of administrative changes associated with calculating qualifying earnings.

DWP has been working closely with employers and the pensions industry to design a self certification model that delivers flexibility for employers without diluting the qualifying criteria in the Pensions Act. As part of those discussions, a light-touch, three-step approach has been developed:

- A scheme can be certified as suitable if it requires, at a minimum, a nine per cent contribution of basic pay (including a four per cent employer contribution); or
- It can be certified as suitable if it requires, at a minimum, an eight per cent contribution of basic pay (with a three per cent employer contribution) provided pensionable pay constitutes at least 85 per cent of the total pay bill; or
- It can be certified as suitable if it requires, at a minimum, a seven per cent contribution of basic pay (three per cent employer contribution), provided that the total pay bill is pensionable.

We have concluded that a certification model along these lines strikes the right balance between regulatory burden and protection for individuals.

Recommendation:
That Government implement this simple certification process.

8.4.4 Other deregulatory options

Removing the NEST contribution cap
In Chapter 6, we discuss in detail the rationale and impacts of removing the NEST contribution cap. There are potential benefits to removing the cap, in terms of providing greater flexibility to employers and employees and reducing administration costs for employers and NEST in monitoring contribution levels. We are also concerned that the contribution limit in NEST sends an unhelpful message about ‘appropriate’ levels of saving. However, these issues are balanced against the likely competition impact of removing the cap. The pensions industry would be opposed to a lifting of the cap, as they see this as one of the primary levers in ensuring that NEST remains focussed on its purpose of meeting the ‘supply gap’ for low to moderate earners and smaller employers.

We have concluded that the cap is probably appropriate whilst NEST is being established and employers are making their initial choices about pension provision. However, once the reforms are bedded in, we feel very strongly that the cap should be removed to facilitate greater flexibility for savers. We are therefore recommending that the Government legislate for the removal of the contributions cap in 2017.

Removing the NEST transfer restrictions

The prohibition of transfers in and out of NEST, other than in limited and specific circumstances is intended to target the scheme on the supply gap which exists at the lower end of the market, and ensure that it complements, rather than competes with the existing pensions market.

However, facilitating transfers is, in our opinion, critical to the longer term success of the reforms. In a world where automatic enrolment makes pension saving the norm, including for low earners and people who move jobs frequently, there is a much higher risk that an individual's pension savings become fragmented in a number of small pots. Our view is that, as pension saving in defined contribution schemes becomes much more widespread, so should moving and consolidating pensions saving when changing employer.

This is, however, an issue that goes beyond how transfer rules are applied to NEST. In the market more generally, transfers are restricted by frictional costs, including the cost of regulation and advice. Our conclusion is, therefore, that there needs to be more wholesale consideration of how transfers can be facilitated much more easily across the pensions market as well as in and out of NEST. We recommend that Government undertakes a further review, in advance of the 2017 review of the restriction on transfers for NEST, to consider how transfers across the pensions industry can be made easier, so that individuals are better able to consolidate their pension savings as they change employment over their working life. This work should ensure that, once the automatic enrolment duties are staged in, we can move quickly to a world where transfers between pension schemes on change of employment, including transfers in and out of NEST, become a more normal practice.

Recommendations:

- The Government legislate for the contribution cap in NEST be removed in 2017.
- Government and regulators should review as a matter of some urgency how to ensure that it is more straightforward for people to move their pension pot with them as they move employer, so that, by the time of the 2017 review, the more general issue of pension transfers has been addressed and NEST is able to receive transfers in and pay transfers out.

8.5 Impacts of the package of recommendations

Full recommendations for immediate change:

- Eligibility threshold increased to £7,336 a year, in line with the threshold for paying tax; bottom of the contributions band to be aligned with National Insurance primary threshold with voluntary opt in between these thresholds.
- Universal waiting period of up to three months, with voluntary opt in during this period.
- Large employers due to be staged in October and November 2012 are able to choose to act early from July 2012.
- Greater flexibility around the timing of re-enrolment.
- Simplified certification process.

Compared with current policy, our package of recommendations has modest implications for the scope and impacts of automatic enrolment:

- One million fewer people eligible for automatic enrolment (-10 per cent against the baseline), with a reduction in total individuals contributions of £180m (-4 per cent).
- An increase in private pension income in 2050 against a non-reform scenario of £15.3bn (in 2010/11 prices); this is slightly lower than under the status quo policy (£16.3bn).
- A reduction in the eligibility for Pension Credit in 2050 of 175,000 households, compared with a non-reform world; this is lower than under the status quo policy (250,000 fewer households on Pension Credit).
- A six per cent increase in spend on Housing and Council Tax Benefits against the status quo policy.
- A reduction in “social welfare benefits” (the benefit in well-being terms of consumption smoothing) of around ten per cent.
- A marginal reduction in employer costs: year one administration savings of £10m (-2 per cent) and £6m (-4 per cent) in ongoing annual administration; employer contribution savings of £140m (-4 per cent).
- A marginal reduction in the amount of tax revenue forgone (as tax relief on pension contributions), by £90m in steady state (-4 per cent).

From this we can see that reductions in eligibility for automatic enrolment against the status quo policy feed through into lower pension contributions and thus higher eligibility for Pension Credit, Housing Benefit and Council Tax Benefit. However, this is balanced against lower costs for employers and also reduced costs for the Exchequer in terms of tax revenue forgone as tax relief on pension savings.

Looking at the profitability analysis in Chapter 7, it is clear that NEST is a necessary part of the reforms under this refined scope. Whilst the changes we are recommending will increase profitability in the market slightly (by eliminating the lowest earners and highest churn employees), a significant proportion of employers would still find it difficult to access pension provision without NEST, unless charges exceed the current stakeholder cap.

The changes we propose will require amendments to primary legislation, followed by additional secondary legislation. We would recommend that these changes be announced as soon as possible, to ensure that employers and payroll providers have enough time to prepare for implementation in October 2012. Analysis from The Pensions Regulator and NEST indicates that these changes would not present significant operational risks.

8.6 Alternative models for delivering pension reform

Overall, we feel that the scope of automatic enrolment is broadly right, and we have therefore recommended only minor changes to scope, with some additional deregulatory measures to ease burdens for employers. This conclusion is based on the premise that we should maximise pension saving as far as possible, and that sweeping reform affecting millions is the way to do this.

However, there are other rational models with more limited potential to deliver a step-change in pension saving. We then consider what the impacts of two different models might be, against the baseline for reform and against our package of recommendations:

- Alternative scenario 1: Eligibility threshold of £14,000, with a three month waiting period and excluding micro employers (with 1-4 employees).
- Alternative scenario 2: Eligibility threshold of £14,000, with a three month waiting period and excluding employers with 1-19 employees, without NEST.

Tables 8.1 and 8.2 set out all the impacts of these models in terms of individuals' savings, employer costs, Exchequer costs and programme costs. We also discuss the potential impacts for NEST of alternative scenario one.

Understanding the impacts for NEST

NEST is designed to be self-financing in the long run through member charges. In the short term there is a funding gap between set up costs incurred and charge revenues, which is being met by a loan from Government. The funding gap depends on the profile of costs and revenues, and this depends (as for all pension schemes) on the numbers and size of employer participating, the behaviour of members and contribution levels. The key parameters for illustrating the funding gap are the "peak funding requirement" (the outstanding balance at the point the revenues start to exceed the costs) and the repayment term of the loan, after which the scheme will have achieved self-funding status.

In terms of the impacts on NEST volumes, the various options will directly exclude some individuals, but will also change the numbers of employers who have no choice but to use NEST, because the pensions industry finds it so unprofitable to serve them. There may also be second-order impacts arising from changes in the policy environment, in terms of employer decisions over which scheme to use.

Table 8.1: Individual and employer impacts

	Eligible goup million	Total participation post reform million	Proportion of excluded group that are women percentage	Increase in private pension incomes £m	Numbers qualifying for pension credit	Spend on housing & council tax benefit £m	Social welfare benefits £bn	Year 1 employer admin costs £m	Steady state annual admin costs £m	Additional contribution costs £m	Employee total conts £m
Status quo policy	10-11	10-14	N/A	16,300	-250,000	-570	40 - 55	444	127	3,240	4,240
Review recommendations	-1.0	-1.0	59	15,300	-175,000	-410	35 - 50	434	121	3,100	4,060
Scenario 1	-4.0	-3.5	44	10,800	-109,000	-270	20 - 30	270	58	2,570	3,360
Scenario 2	-5.4	-4.8	46	6,300	-57,000	-210	15 - 25	158	31	2,010	2,630

Estimates of increases in private pension income in 2050, at 2010/11 prices; these figures represent the central scenario.
Annual figures for Pension Credit entitlement compared with a world with no private pension reform.
Social Welfare estimates for the period up to 2050; figures compared against a world with no private pension reform.

Source: Department for Work and Pensions modelling.

Table 8.2: Impacts on Exchequer and programme costs

	Tax relief £m	Exchequer cost £m	NEST volumes million	Repayment date	Peak funding £bn
Status quo policy	1,200	2,010	2 - 6	A couple of decades	0.5 - 1
Review recommendations	1,150	1,920	2 - 5	Around a one year increase on status quo	Negligible change
Scenario 1	940	1,570	See text	See text	See text
Scenario 2	720	1,220	N/A	N/A	N/A

Source: Department for Work and Pensions modelling.

8.6.1 Alternative scenario one

Impacts on individuals

Increasing the threshold for eligibility to £14,000, excluding micro employers and introducing a three month waiting period would significantly reduce the number of eligible workers, and the final figures for participation in pension saving, compared with both the status quo policy and our recommended scenario. This scenario would reduce the number of people eligible for automatic enrolment by 38 per cent; by contrast, our recommended position reduces eligibility by 10 per cent. Fewer numbers automatically enrolled naturally results in lower private pension incomes in 2050, which would be 34 per cent lower under scenario one compared with the status quo. This is nearly six times greater than the impact of our recommended approach. At the same time, more people will end up needing Pension Credit than would be the case under our proposals, or the status quo policy (Table 8.1).

Lower private pension incomes will have a knock on effect on other benefits, such as Housing Benefit and Council Tax Benefit, and thus cost to the Exchequer in the long term. We estimate that scenario one would result in a 50 per cent smaller saving on these benefits compared with the status quo.

Impacts on employers

Reducing the number of eligible workers leads to lower costs for employers, who face contribution costs with 21 per cent lower under scenario one compared with the status quo. This is compared with a reduction in contributions of four per cent for our recommendations against the status quo policy. Administration costs would also be reduced, since employers will be undertaking fewer automatic enrolment activities. These costs would be reduced by around 40 per cent in year one and then 21 per cent annually in steady state, compared with the status quo policy.

Impacts for the pensions industry and NEST

Assuming charges of 0.5 per cent AMC plus a three per cent contribution charge, under this scenario, half of employers with five-nine employees are not profitable to the pensions industry.

An intervention like NEST would, therefore, still be necessary to achieve 100 per cent coverage under this scenario. However, this option has potentially significant consequences for the number of members in NEST compared with the status quo policy. A significant proportion of the supply gap that NEST is intended to fill would no longer exist. This would begin to undermine the achievement of economies of scale that are necessary to ensure that NEST can both offer a low cost pension to its members and be financially viable in its own right. It is difficult to predict precise volumes for NEST under this scenario, as the decisions of employers and the exact margins of the supply gap become very significant. However, there is a significant risk that government would need to support NEST with loan funding over a much more significant period and, in worst case scenarios, NEST may need an on-going subsidy in order to continue to provide a low cost product to all its members.

An alternative would be to allow charges to rise to increase profitability in the pensions industry, allowing existing providers to meet the supply gap. Our analysis suggests that charges at the stakeholder cap may be sufficient to achieve this, but this is sufficiently marginal that, even with charges at this level, we cannot conclude with any confidence that the entire supply gap would be eradicated.

Impacts on programme costs
Fewer savers under this scenario will lead to less tax relief on pension savings, such that the Exchequer would make savings of around 22 per cent compared with the status quo. However, as previously mentioned there would be comparative costs in the long term in the form of lower savings on Housing and Council Tax benefits and Pension Credit.

Excluding micro employers would result in lower costs relating to The Pensions Regulator, since these employers comprise the highest risk and thus will incur the greatest costs in chasing and enforcing compliance with the duties.

8.6.2 Alternative scenario two
This scenario is more extreme than scenario one, in that it involves excluding all employers with fewer than twenty employees, to illustrate a scenario in which NEST would not be necessary to support the reforms.

Impacts on individuals
This scenario would more than halve the number of people eligible for automatic enrolment, and reduce the total participation in private pension saving post-reform by 39 per cent compared with the status quo. This would lead to a reduction in private pension incomes in 2050 of 61 per cent and an increase in the numbers claiming Pension Credit in 2050 when compared with the status quo policy (Table 8.1). This would also lead to more people needing to claim other benefits in 2050 compared with the status quo.

The absence of NEST offering a low-cost option would also mean that some individuals incur higher charges than they otherwise might experience.

Impacts on employers
Contribution costs would be around 38 per cent lower for employers under scenario two compared with the status quo, and administration costs would be 64 per cent lower in year one and 76 per cent lower annually in steady state, compared with the status quo.

Impacts for the pensions industry
Assuming universally low charges of 0.5 per cent AMC plus a three per cent contribution charge, Chart 7.9 shows that 80 per cent of employers with 20 or more employees would be profitable. Thus under this scenario the pensions market would be able to meet the demand created by automatic enrolment, with 100 per cent coverage. It is likely that the largest employers could be offered charges lower than this.

Impacts on programme costs
This option would result in savings to the Exchequer (in the form of lower tax relief on pension savings) of 39 per cent against the status quo. However, this would be partially offset by longer term costs in the form of greater expenditure on Housing and other benefits. Under this scenario, there would be no cost of providing NEST, which would otherwise be in receipt of a Government loan in the short term. Such extreme eligibility restrictions would undoubtedly result in lower compliance costs; however it is unclear what the scale of these would be, since The Pensions Regulator would need to redesign their approach entirely under this option.

8.6.3 Summary

Our recommended approach balances small reductions in the numbers of savers and amounts of pension savings against slightly reduced burdens for employers, in the form of reduced contribution costs and administrative costs. At the same time, a number of deregulatory changes significantly simplify the automatic enrolment process, improving the experience for employers and making it easier for them to understand and comply with the duties.

The two more extreme scenarios we have considered would be much cheaper for employers and for the Exchequer, albeit some of the gains in lower tax relief would be offset by higher benefit costs in the long term. Scenario one creates a situation where we can neither be confident that NEST would achieve sufficient scale to be financially viable, nor that the entire demand from automatic enrolment would be sufficiently profitable for the pension industry to take up the slack. In scenario two, there would be no need for NEST. However, these cost savings are balanced by significant reductions in the total numbers of savers and reduced pension incomes for those that are automatically enrolled at some point.

8.7 Further considerations for Government

8.7.1 Communications

In addition to the deregulatory changes we are recommending, we feel very strongly that good communications will be key to minimising the burden for employers, and particularly small employers. Automatic enrolment and the various employer duties underlying this are new and potentially complex. We anticipate that there could be a significant burden for employers in simply understanding what they must do in order to comply, and in choosing the best options for them and their employees. Stakeholders have consistently highlighted the importance of good guidance and information to ease burdens on employers, and we agree that this is likely to be central to compliance.

Recommendation:
We recommend that Government focus significant energies on ensuring effective communications to lead up to and accompany the reforms.

In conducting this review we have also highlighted a number of further issues that are out of scope, but we feel are very important.

8.7.2 Regulatory arbitrage

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

Recommendation:
This is an issue that goes well beyond the scope of this review. But it is an important one and one about which we are very concerned. We recommend that government needs to examine this issue as a matter of some urgency.

8.7.3 DC Risks work

Linked to this point, we are aware that The Pensions Regulator instigated a review of risks in defined contribution schemes in September 2009. Their rationale for the review was a concern that a combination of pre-existing factors relating to defined contribution provision (e.g. high charges, quality of retirement processes and standards etc.) along with the increase in provision through automatic enrolment could lead to an increase in the number of badly run schemes and poorer outcomes for members. The Pensions Regulator will be working with DWP, HM Treasury and the FSA on this project over the coming months.

Recommendation:
We feel that this work is important, and recommend that the Government should continue with work to review whether the existing regulatory regime for the provision of defined contribution workplace pensions remains appropriate in the post automatic enrolment world.

8.7.4 Transfer arrangements

Most people move between employers many times in their working lives, about 11 times on average. If they move between employers with different pension schemes they could easily end up with 11 or more different pension pots on retirement. This is difficult for individuals to deal with and expensive and inefficient for pension providers. But regulation makes moving pensions between one scheme and another very difficult and few people do so. We believe that for the pension reforms to be truly effective it will need to be straightforward, indeed the norm, for people to move their pension pot with them as they move employer.

Recommendation:
We believe that government and regulators need to review this issue as a matter of some urgency.