Background to the review

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Summary

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

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

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

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

1.1 Introduction

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

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

1.2 The Pensions Commission

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

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

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

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

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

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

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

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

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

1.2.1 Automatic enrolment

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

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

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

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

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

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

1.2.2 The case for a National Pension Saving Scheme

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

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

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

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

3 McKay, S, 2006, "Employers' Pension Provision Survey 2005", Department for Work and Pensions Research Report No 329.
4 Horack and Wood, 2005, "An evaluation of scheme joining techniques in workplace pension schemes with an employer contribution", Department for Work and Pensions Research Report No 292.
5 Choi, Laibson and Madrian, 2004, "Plan design and 401(k) savings outcomes", Boettner Centre for Pensions and Retirement Research Working Paper. Madrian and Shea, 2001, "The power of suggestion: Inertia in 401(k) participation and savings behaviour", The Quarterly Journal of Economics, vol.116, issue 4, pages 1149 - 1187.
6 Madrian and Shea, 2002, in Munnell and Sunden, 2004, "Coming up short: The challenge of 401(k) plans", The Brookings Institute.
7 "KiwiSaver Evaluation: Annual Report 1", 1 July 2007 – 30 June 2008, Evaluation Services, Inland Revenue, New Zealand, September 2008.

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

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

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

1.3 Developments since the Pensions Commission reported

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

Table 1.1: Developments since the Pensions Commission Report

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

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

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

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

1.4 The current policy

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

1.4.1 The scope of the policy

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

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

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

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

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

Table 1.2: The scope of automatic enrolment

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

Table 1.2: The scope of automatic enrolment (*continued*)

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

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

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

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

1.4.2 The NEST model

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

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

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

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

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

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

1.5 The review

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

They ask us to consider:

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

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

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

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

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

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

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

1.5.1 The review team approach

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

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

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

Analysis

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

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

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

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

Consultation

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

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

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

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

1.6 Report structure

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

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

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

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

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

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

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