

# Employers

# 3

## Summary

In this chapter we explore how the proposed reforms impact on employers.

Automatic enrolment will have a major impact on employers. They will have a new and significant set of responsibilities with which they have to comply.

The large majority of employers are very small. Two thirds, about 800,000, have fewer than five employees. Most small and micro employers have no experience of dealing with pensions. Their duties under this policy will involve them in, for many, an entirely new set of issues.

Bigger employers are much more likely to run pensions schemes. For them, key considerations will be whether their current scheme meets the automatic enrolment minimum standards and what automatic enrolment will mean for the level of participation in their scheme.

Costs to employers can be divided into two distinct elements. First, the contribution costs to the employer of providing the three per cent minimum contribution to employees who remain in pensions saving. These costs represent a transfer to the employee, rather than a pure cost in economic terms. By contrast, administrative costs – for example the cost of setting up a pension scheme, automatically enrolling employees, calculating and deducting contributions, and registering with The Pensions Regulator – represent a true economic cost.

We want to minimise these administrative costs as far as possible and ensure that they are proportionate to the benefits of automatic enrolment in terms of the additional pension saving generated, particularly for the smallest employers, for whom the reforms have potentially the greatest impact. Inevitably, the cost per employee enrolled will be much higher for smaller employers. In addition, the costs for the Pensions Regulator of dealing with many hundreds of thousands of small employers will be large.

### 3.1 Introduction

The driving force behind automatic enrolment is that too few people are saving enough to provide the standard of living they would like in retirement. Allied to this is a gradual decline in the provision of workplace pension schemes and, in particular, defined benefit schemes, although many people do work for firms that offer pensions of which they do not take advantage. The premise of the proposed reforms is that, short of requiring people to save, the best means of encouraging saving is to automatically enrol individuals into a pension. This requires the provision of a pension scheme in which to save and someone to carry out the automatic enrolment process. In the context of the UK pension provision, this role falls most naturally on an individual's employer.

Undertaking this role inevitably carries a cost for employers, both in terms of their own contributions to an individual's pension and in administering automatic enrolment. As explained in Chapter 1, under the current policy design, employers are required to make a minimum contribution of three per cent of a band of earnings between £5,035 and £33,540 (2006/07 prices, to be updated in 2012). For many employers, particularly the smallest employers, providing workplace pensions will be an entirely new role, with a new administrative burden in addition to the costs of making contributions. As the reforms are currently intended to apply to any employment relationship, many people we might describe as "accidental employers" will be caught up in the requirement to automatically enrol their contracted workers – for example, those employing carers and nannies.

A central question for the review to consider is whether this burden on employers is both necessary and proportionate in achieving the policy aims of increasing retirement saving, and whether there are opportunities for these costs to be reduced.

This chapter examines the implications of pension reform for different types of employer (Section 3.2), the administrative costs associated with pensions reform (Section 3.3), the contribution costs for employers (Section 3.4), the role of The Pensions Regulator in ensuring compliance with the duties (Section 3.5) and evaluation of the regulatory burden employers face (Section 3.6).

The analysis in this chapter informs discussions on profitability in the pensions industry (Chapter 4 and 7), the discussion of changes to the target group for automatic enrolment (Chapter 5) and the deregulatory options to simplify the administrative processes for employers and schemes (Chapter 6).

### 3.2 Implications of the reforms for employers

The duties set out in the 2008 Pensions Act will apply to all companies or individuals who employ one or more workers in Great Britain. Complying with the reforms will entail new roles and processes for all employers, for example in carrying out automatic enrolment into a workplace pension and in registering with The Pensions Regulator. In addition, for many employers, and particularly small (fewer than 50 employees) and micro (fewer than five employees) employers, the process of providing a workplace pension in itself will be new. Employers with existing pension provision will have to go through new processes to ensure that their schemes comply with the requirements for scheme quality, and to take decisions regarding their contribution levels.

### 3.2.1 Employer processes under the reforms

During implementation, employers are brought into the duties in a managed way called ‘staging’<sup>35</sup>. This staging period runs from October 2012 to September 2016. Employers are assigned a staging date, when they must first automatically enrol eligible workers into a qualifying workplace pension scheme. The largest employers are staged first (using PAYE scheme size as a proxy for employer size) through to the smallest. New firms coming into being after October 2012 will be brought into the reforms at the end of the staging period. All employers will receive letters from The Pensions Regulator 12 months and then 3 months ahead of their staging date. The letter will tell them when their staging date is and what they must do to comply with their automatic enrolment duties. The Pensions Regulator will publish guidance to help employers understand their duties.

Employers will have to undertake a series of tasks in order to comply with the new duties. Figure 3.1 sets out the time line for the step by step processes. Employers must:

- Offer a qualifying pension scheme with a minimum contribution of eight per cent of a band of qualifying earnings, with at least three per cent from the employer for defined contribution schemes.<sup>36</sup>
- Automatically enrol all eligible jobholders on their staging (automatic enrolment) date<sup>37</sup> and make contributions to a qualifying pension scheme during a one-month joining window.
- Provide information to jobholders during the one-month joining window to let them know they are being automatically enrolled and have the right to opt-out in the month after automatic enrolment.
- Facilitate opt-out and make refunds to those who have opted out.
- Register with The Pensions Regulator and provide them with information on how they met their automatic enrolment duties within two months of their staging date.

After their initial staging date, employers must do the following on an ongoing basis:

- Identify and automatically enrol newly eligible jobholders on day one of their employment or who are newly eligible because they have reached age 22 or have qualifying earnings.
- Process workers who opt-in to pension saving, making an employer contribution if a jobholder is between age 16 and 21 or between state pension age and 74 with qualifying earnings, but not being required to make an employer contribution if the worker does not have qualifying earnings.
- Provide information to jobholders.
- Administer opt-outs and refunds within the prescribed time periods.

35 3% employer contribution at the end of the implementation period. During implementation, contributions are phased in for money purchase schemes at 1% from October 2012 to September 2016, at 2% from October 2016 to September 2017 and at 3% from October 2017.

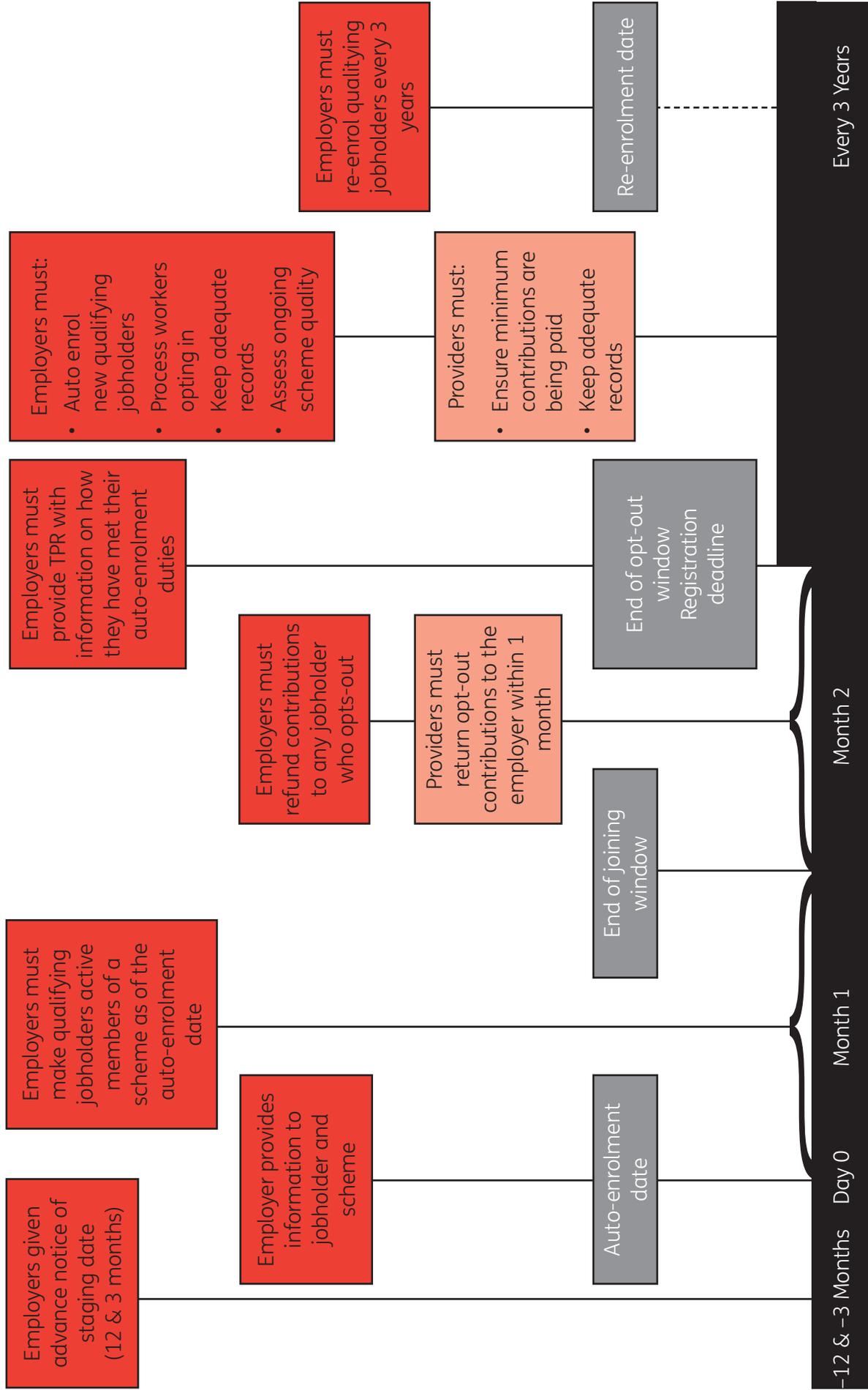
36 For Defined Benefit schemes all schemes contracted out of the State Second Pension will be considered compliant. Other non-contracted out schemes must meet the ‘Test Scheme Standard’. The employer compares the benefits received under their scheme to those under the ‘Test Scheme’ which includes accrual rate of 1/120th. Hybrid schemes must satisfy the DB and DC test in proportion to the benefits provided.

37 Employers with a staging date on or after 1 November 2012 can bring forward their staging date to another staging date prescribed in the regulations so long as they have a qualifying scheme that will accept them and have registered with The Pensions Regulator.

- Re-enrol eligible jobholders who opted out of the scheme on the third anniversary of the employer's staging date.
- Keep records (for a minimum of six years) about jobholders, workers and about the pension scheme, demonstrating how they have complied with the duties under the Act.

Section C.2.1 in Annex C provides further information about the detailed processes employers must follow to comply with their duties.

Figure 3.1: Employer processes



### 3.2.2 What the reforms mean for different types of employers

Employers will face additional contribution costs as a result of these reforms. We discuss in Section 3.4.3 how employers might choose to finance contribution costs. Contribution costs represent a real cost to employers but, as the money is transferred to the employee, in economic terms these constitute a “transfer payment” rather than a true economic cost. Many employers tend to see the rationale, and the benefits to the employee, of the contribution costs. DWP research in 2006 reported that six in ten employers felt that a minimum employer contribution was a good idea<sup>38</sup>, and in the Association of Consulting Actuaries’ 2010 survey of small and medium sized firms, fewer than two in ten respondents felt that the employer contribution should be reduced, with a quarter thinking the levels should be increased<sup>39</sup>.

The administrative cost to the employer of setting up and administering automatic enrolment is, by contrast, a pure economic cost from which nobody gains. These should, therefore, be minimised as far as possible.

The size of the contribution costs, and to some extent of the administrative costs, is dependent on the employer’s existing pension and administration arrangements. Employers with existing good quality schemes will have to do less in the way of new administration to comply with the reforms, and will face smaller additional costs of contributions compared with employers who have no provision. Thus, in order to understand the impacts of the reforms, we must first look at who the employers are.

There are currently 1.2 million private sector organisations in the UK, employing a total of 19.2 million individuals. Table 3.1 shows key information about UK employers, with a particular focus on the smaller employers<sup>40</sup>, who will have the greatest per employee burden associated with automatic enrolment.

Overall, we can see that the majority of UK employers are small or very small but employ a minority of the workforce: while micro employers represent 66 per cent of all employers, they employ only 12 per cent of the workforce. The majority (72 per cent) of workers are employed by firms with at least twenty employees. This means that strategies targeted at reducing burdens for micro employers would potentially have a more limited impact on workers.

There are no apparent relationships between gender distribution and employer size, but there seems to be a consistent relationship between employer size and average salary of their workforce. For companies who employ at least twenty workers, seven in ten of their employees earn at least £15,000 per annum. By contrast, only around four in ten individuals who work for micro employers earn £15,000 or more.

Annual job churn will be a key factor in the cost of complying with the reforms, as this will dictate the numbers of automatic enrolment processes and scheme leavers employers will have to process and the size of the scheme records they must keep. There is a trend in job churn by employer size, with the smallest firms having the highest proportion of workers with less than a year’s tenure. Even the largest firms experience around ten per cent annual workforce churn, with an average of 14 per cent overall.

38 Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, “Employer attitudes to personal accounts: Report of a quantitative survey”, DWP Research Report No 397.

39 ACA, 2010, Survey of smaller firms views on automatic enrolment and NEST.

40 Throughout our analysis in this chapter we disaggregate small (with fewer than 50 employees) and micro firms (with fewer than five employees) into sub-groups.

There is also a clear relationship between pension provision and firm size, with larger companies being much more likely to provide any access to pension schemes, and to provide a contribution. This means that the smallest companies will be disproportionately affected by the costs of pension reforms. Whilst pension scheme membership tends to be high where micro employers offer pension provision, so few do so that the majority will be facing contributions for the first time.

	Employer size number of employees					All
	1	2-4	5-9	10-19	20 +	
Employers row percentages	16	50	18	9	6	100
Proportion of total UK workforce row percentages	2	10	8	8	72	100
<b>Earnings of workers employed by firms within each size category column percentage</b>						
<£5,000	13	13	11	9	8	8
£5,000 – £9,999	28	25	17	13	11	12
£10,000 – £14,999	21	19	18	17	13	14
£15,000 – £19,999	15	15	17	17	15	16
£20,000+	24	29	37	44	53	51
Proportion of workforce who are women percentage	44	48	46	44	50	50
Annual workforce churn percentage	17				12	14
Proportion of employers offering any pension provision percentage <sup>1</sup>	8	5	24	33	52	15
Proportion of employers offering pension provision with a contribution percentage <sup>1</sup>	8	3	20	24	44	12
Average proportion of employer's workforce that are members overall (those with provision only) percentage <sup>1</sup>	–	76	46	44	31	32
Average proportion of employer's workforce that are members of a pension scheme AND receive employer contributions (those with provision only) percentage <sup>1</sup>	–	53	41	36	29	30

1 Only including employers with at least one active member.

Sources: Small and Medium Enterprise Statistics, United Kingdom 2008, Department for Business, Innovation and Skills. Annual Survey of Hours and Earnings, Great Britain 2009, Office for National Statistics. Employers' Pension Provision Survey, Great Britain 2009, Department for Work and Pensions.

Overall, we can divide employers into five broad groups, based on the degree of change they will have to make to their existing pension arrangements in response to the reforms. The first two of these five groups will face the least change. They are familiar with making decisions about pension provision, and can be confident that they already contribute enough to meet minimum quality requirements. These employers may want to use the simple certification process for scheme quality described in Chapter 6.

***(1) Employers who currently contribute at least six per cent to a scheme with unrestricted eligibility***

Around 45,000 employers fall into this category, representing 3.5 per cent of the total UK employer population. Larger employers are over-represented in this group, which accounts for 19.5 per cent of the total UK workforce. Three in ten of the largest employers (500+ employees) fall into this group, compared with only two per cent of micro employers.

***(2) Employers who currently contribute at least six per cent to a scheme but restrict eligibility through waiting periods***

Around 11,000 employers fall into this category, representing just less than one per cent of the total UK employer population. No micro employer falls into this category, with nearly three-quarters being small firms and just under a quarter being medium-sized (50 – 249 employees). This group employs 7.5 per cent of the UK workforce, and tends to have high scheme membership rates.

On the whole, definitions of pensionable pay are more generous than the definition of qualifying earnings under the Pensions Act 2008, so employers currently making contributions of six per cent or more of pensionable pay are contributing in excess of the minimum required by reform. They will have to make some administrative changes to introduce automatic enrolment and, potentially, to extend eligibility criteria, but most will already have computerised administrative systems and may have dedicated staff to undertake such activities. Participation rates are high across firms contributing more than five per cent, so this group of employers will face the smallest proportional increase in costs due to contributions. This group also have the option to offset increases in contribution costs through levelling down. As such, we are not focusing on these first two groups of employers in deciding on potential changes to the reform policy.

The other three groups of employers have no or limited experience of pension provision. Where they do provide a pension, it may not meet the quality requirements under the reforms.

***(3) Employers who currently contribute between two and five per cent***

This group of employers have reasonable provision, but due to the differences between the current basis for pension calculations and the definition of qualifying earnings under the 2008 Act, this group of employers cannot be confident that their schemes meet minimum contribution requirements. Six per cent of all employers fall into this “marginal provision” category, accounting for 22.7 per cent of the UK workforce. Half of all large firms, and three in ten very large firms come into this category, compared with only two per cent of micro employers.

These employers have experience of pension provision, but will potentially face complex and burdensome calculations to decide whether or not their schemes qualify under automatic enrolment. They may have to make changes to eligibility criteria, as well as introducing automatic enrolment. We are keen to reduce the regulatory burden for these employers as far as possible, making it easier for such firms to determine whether their schemes qualify.

#### *(4) Employers with very low quality pension provision*

This is a relatively small group of 48,000 employers representing four per cent of the total UK employer population. Nearly two thirds of these employers are small, with a further quarter being micro employers. This group of employers accounts for nine per cent of the UK workforce.

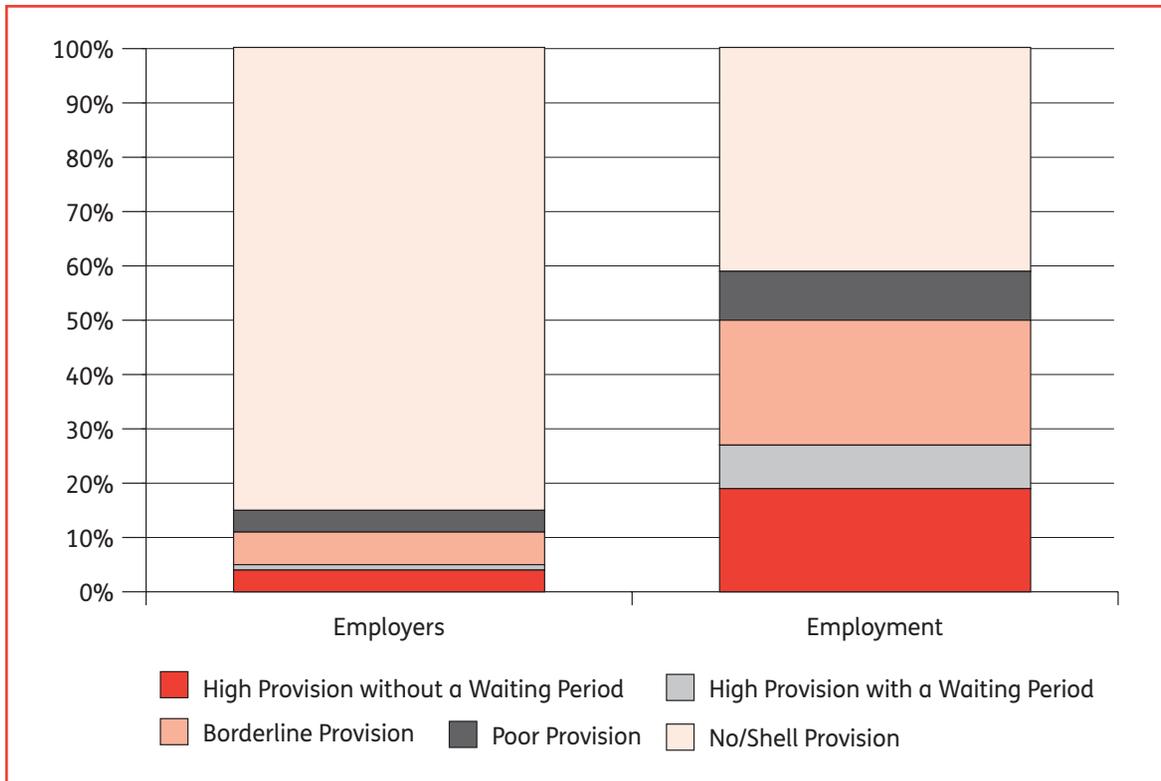
While this group of employers offer a workplace pension scheme, the current contribution rates are too low to meet the minimum scheme quality requirements for automatic enrolment. These employers will either need to increase the contributions to their current scheme or offer a new scheme with a higher contribution rate. Participation in these schemes is also lower than higher quality schemes, meaning that these employers will have proportionally more automatic enrolment activity to undertake at implementation than other existing providers. As this group is mainly populated with small and micro employers, it will have high rates of employee churn and so will also have to undertake proportionally more automatic enrolment activities per year than other groups of existing providers.

#### *(5) Employers with no pension provision*

These employers, primarily micro employers without pension provision and small employers with empty stakeholder schemes, make up 86 per cent of UK employers, and employ more than 40 per cent of the workforce. 94 per cent of all micro employers and 71 per cent of small employers fall into this category, along with two fifths of all medium sized firms, three in ten large firms, and two in ten very large firms.

Many of these employers will have to make decisions about pension provision for the first time and will have no experience of any of the processes involved in complying with the duties. Given the predominance of small and micro employers, this group also has the highest rates of employee churn, between 14 and 17 per cent, and will have to undertake proportionally more automatic enrolment activities per year than other groups of employers. Most will also be making contributions for the first time and thus face the highest proportional costs of all employers. We are very concerned to reduce the regulatory burden on these employers as far as possible and, in particular, to ensure that the costs of complying with the duties do not outweigh the contributions made on behalf of members.

**Chart 3.1 illustrates the proportion of employers and employees falling into each of these five categories.**



Source: Employer Pension Provision Survey 2009, Department for Work and Pensions.

### 3.2.3 Current pension provision and its quality matter

The existence and quality of current pension provision by employers is crucial to our grouping of employers in Section 3.2.2. This section explores in more detail the extent, type and coverage of current pension provision, the quality of schemes, and current joining methods.

#### Number and type of schemes

In 2009, 38 percent of private sector employers made some form of pension provision for their employees, albeit some of these have no active members in their schemes and some employers (five per cent of all employers) made contributions to individuals’ personal pensions rather than providing a workplace scheme. Pension provision is more common among larger organisations than among smaller ones. Consequently, the proportion of private sector employees who worked for a pension-providing employer was considerably higher (86 per cent), although not all of these employees will be eligible to join their employer’s scheme, and, in fact, only 37 per cent, or 7 million, employees were members of pension schemes<sup>41</sup>.

<sup>41</sup> Bewley H and Forth J, 2010, “Employers’ attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey”, Department for Work and Pensions Research Report No 683

The most common form of provision was a stakeholder pension scheme (SHP) (provided by 27 per cent of employers with provision), followed by contributions to employees' private personal pensions (14 per cent of employers with provision). Small proportions of employers provided either group personal pensions (GPP) or occupational pension schemes, around one in twenty in each case. The providers of occupational schemes and GPP schemes tend to be relatively large, however, and so 49 per cent of employees work for companies with occupational schemes and 30 per cent for employers with GPP schemes.

Most employers with workplace pension provision have a single workplace pension scheme (79 per cent). Some employers provide more than one scheme. Just over half of these employers have different types of schemes, for example occupational and stakeholder pension schemes, which they may offer to different types of employees. The provision of multiple workplace schemes was more common in larger organisations and, for this reason, 64 per cent of employees in organisations with workplace pension schemes were employed by an organisation with more than one workplace scheme. This corresponds to around half (52 per cent) of all private sector employees working for a company with more than one workplace pension scheme. This differentiation in provision for different groups of employees suggests that, once the reforms are in place, some larger employers may seek to use alternative provision, possibly including NEST, for some parts of their workforce, while retaining existing schemes for current members or members who have been with the employer for, say, two years.

### *Scheme quality: contributions, pensionable pay definitions and charge levels*

Around four-fifths (79 per cent) of employers who offered access to a pension scheme made a contribution, with the contribution rate most commonly being at least six per cent of an employees' salary (Table 3.3). Larger firms tend to be more likely to make contributions (Table 3.2), and contribution rates are highest, on average, for occupational schemes (Table 3.3).

**Table 3.2: Employer contribution rates in the employer's largest scheme by employer size**

Rate of contribution to largest scheme	Employer size number of employees						
	1-9	10-19	20-49	50-249	250-499	500+	All
Less than 3%	4	4	11	16	7	2	6
3% exactly	6	16	13	8	6	4	9
3.1%-5.9%	19	21	23	36	26	23	21
6% or more	51	41	33	28	51	54	45
No contributions	21	19	21	12	10	16	20
<i>Weighted base</i>	236	71	48	33	4	5	397
<i>Unweighted base</i>	64	120	227	521	228	362	1522

Base: All employers offering access to a pension scheme.

Source: Bewley, H and Forth, J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

**Table 3.3: Employer contributions rates in the employer's largest pension scheme, by scheme type**

	Percentage			
	Stakeholder pension scheme	Group personal pension	Occupational pension scheme	All
<b>Any employer contribution</b>	71	94	93	79
<b>Contribution rate:</b>				
Zero	29	6	7	21
0.1-2.9%	7	5	2	6
3.0% exactly	7	19	1	9
3.1-5.9%	18	39	6	21
6.0%+	40	30	84	44
<i>Weighted base</i>	260	79	58	397
<i>Unweighted base</i>	543	590	390	1,523

Base: Largest workplace pension scheme, with some active members.

Source: Bewley, H and Forth, J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

Contribution rates are only one measure of scheme quality, since the basis on which contributions are calculated can vary between employers, meaning that a six per cent contribution from one employer may be worth more or less than a six per cent contribution from another. "Pensionable pay" can include varying proportions of basic pay (salary) and additional elements of total pay (including overtime, commission, bonuses etc.). On average, however, basic pay tends to make up more than 90 per cent of total pay.

Under the Pensions Act 2008, the total minimum contribution to defined contribution schemes must be equivalent to eight per cent of "qualifying earnings", which comprises a band of gross earnings, between £5,035 and £33,540 (in 2006/07 terms). Gross earnings include salary, commission, bonuses, overtime, sick pay, and maternity and paternity pay. For many employers, there is likely to be a mis-match between their definition of pensionable pay and the definition of qualifying earnings. However, contributions based on pensionable pay exceed contributions based on the definition of qualifying earnings for 90 per cent of members across all sizes. A simple certification process to help employers check whether their scheme meets the quality requirements is discussed in Chapter 6.

Another key element of scheme quality is the level of charges paid by members and the extent to which this represents value for money. For example, for a median earner with a full saving history, an annual management charge of 0.5 per cent would reduce their final fund value by nine per cent, but, if the charge is set at 2.5 per cent, they would lose up to 37 per cent of their total fund value. Chapter 4 discusses charge types and profitability for pension providers and also sets out the impact that charge levels have on members' funds (Chart 4.1).

The majority of occupational scheme charges are paid wholly or partly by the employer, but one in five are paid wholly by the employee<sup>42</sup>. The most common percentage fund charge level is one per cent. Charge levels usually decline as schemes get larger, and the smallest schemes are charged at a level nearly twice as high as the largest schemes (mean level of 1.53 per cent for schemes of under 12 members compared with 0.84 per cent for 100+ members).

Basic annual charge levels on contract-based schemes are similar to those in trust-based schemes, but are generally paid by the member rather than the employer. Based on information provided by eight insurers, covering over 3,000 schemes, for around one-third of schemes the standard basic annual management charge is lower than 0.8 per cent, while, for almost half (45 per cent) of schemes sold by providers, annual management charge levels are one per cent or higher. AMCs tend to vary with scheme size, with smaller schemes attracting slightly higher charges; nevertheless, the majority fall at or under the stakeholder charge cap of 1.5 per cent in the first ten years and 1 per cent thereafter (see Table C.2.2.1 in Annex C).

### *Scheme membership rates*

Unsurprisingly, participation in pension schemes varies by the level of contribution offered by the employer. Where the employer offers no contributions, only around three in ten employees join the scheme on average. By contrast, where the employer offers contributions of six per cent or more, almost two-thirds of employees on average join the scheme. There is corresponding variation by type of scheme: stakeholder schemes attract only two in ten employees, whereas occupational schemes attract almost seven in ten employees. This is because type of scheme tends to be a flag for level of contribution, with occupational schemes having the highest, and stakeholder schemes the lowest, average employer contributions (see Table C.2.2.2 in Annex C).

### *Eligibility criteria & joining mechanisms*

Even among schemes that are open to new members, some employers operate waiting periods or have other eligibility criteria restricting scheme membership. A third (33 per cent) of employers with pension provision used a waiting period and just over one in ten used some other form of eligibility criterion, either on its own (eight per cent) or in combination with a waiting period (four per cent). These criteria included: senior management only, employees having to be over a certain age, white collar or blue collar employees only, or all in a particular business group. (See Table C.2.2.3 in Annex C).

For organisations where a waiting period was in operation before joining a pension scheme, the majority (64 per cent) operated a waiting period of 6 months or under. This includes a third (33 per cent) who required employees to wait for 3 months or less before joining a scheme. There were no clear variations by employer size, but those who made contributions to their employees' pensions were less likely to offer an unrestricted scheme than those who did not contribute (48 per cent compared with 62 per cent). Chapters 5 and 8 discuss our recommendations for a waiting period. (See Table C.2.2.4 in Annex C).

<sup>42</sup> DWP survey of occupational scheme trustees and of insurers provides a summary of charge levels across both contract-based and trust-based schemes: Croll, A, Vargeson, E and Lewis, A, 2010, "Charging levels and structures in money-purchase pension schemes: Report of a quantitative survey", Department for Work and Pensions Research Report No 630.

The cornerstone of the pension reforms will be the introduction of automatic enrolment into pension schemes. Under this legislation, for the first time individuals will be put into pension schemes without providing any form of consent beforehand. Whilst this is not currently possible, some employers try to make it easier for their employees to join a pension scheme by simplifying the joining process in some way, up to and including a form of “automatic enrolment” (in which the individual is given the opportunity to opt out of joining before they are put in the scheme). Of those employers who offered access to pension provision in 2007, a third use a streamlined process (32 per cent), and six per cent used some form of “automatic” joining process (See Table C.2.2.5 in Annex C).

The joining method chosen had a dramatic effect on membership levels, with around eight in ten eligible employees joining a pension scheme via an “automated” process, compared with only a third where they were required to complete a detailed form. This is in line with the Pensions Commission’s core reasoning behind the pension reforms, that automatic enrolment harnesses inertia to improve pension take up.

### 3.3 Administrative costs for employers of complying with the reforms

“Administrative cost” refers to the cost to the employer of carrying out the various activities needed to meet the automatic enrolment requirements. Often, this will depend on the time taken to carry out the activity, the hourly wage of the individual carrying out the task and how many times the task must be completed.

To some degree, we can learn about the potential administrative burdens of pension reform by examining the impacts of other regulatory regimes that have required employers to undertake new administrative processes. DWP research<sup>43</sup> has attempted to explore administrative burdens by asking employers about the overall effects of legislation such as maternity/paternity leave rights, the stakeholder pension requirements and HMRC moving to electronic filing of tax returns.

Typically, small employers said they relied on outsourcing services and seeking external advice and, therefore, they found the process quite manageable. Those operating payroll in-house were heavily reliant on their software provider for automatic updates to help them deal with previous legislation such as the minimum wage, or change in VAT. They were positive about how useful these were in making such changes trouble free. When difficulty had arisen with previous changes, this was due to two key issues:

- Complexity: Small employers struggled most with reforms that required a large amount of paperwork and legal advice that could not be generalised to all employees. The more complex the employers found the legislation, the more the cost of dealing with the legislation would increase as employers spent more time implementing it and there was a greater likelihood of them having to seek external advice.
- High up-front costs: Implementing previous legislative reforms became more of an issue, or perhaps more memorable, for small employers, when they involved a high degree of cost up front.

<sup>43</sup> Philpin, C and Thomas, A, 2009, “Understanding small employers’ likely responses to the 2012 workplace pension reforms”, Department for Work and Pensions Research Report No 617.

Broadly, we can divide the administrative duties associated with automatic enrolment into four groups. Preparing for start up involves investigating existing schemes, taking internal decisions about how best to provide a qualifying scheme, training staff and communicating with employees. Enrolment involves providing information to eligible jobholders, enrolling them, dealing with opt outs, passing information to the scheme etc. Collection and administration involves calculating and deducting contributions, paying them over to the scheme and dealing with requests to stop payments. Finally, registration involves interacting with The Pensions Regulator to provide information on the activities the employer has taken to meet their duties.

For employers with no previous experience of pension provision, the upfront costs may be relatively high, in researching and setting up a new pension scheme, and, potentially, in making changes to their payroll systems.

DWP has estimated the administrative costs to employers across different sizes, covering both first year costs and ongoing costs in steady state (Section 3.3.2). We have also explored employers' views of the potential administrative costs of the reforms, directly through consultation (Section 3.3.1).

We have also looked for comparisons with equivalent pension regimes in other countries. A number of other regimes bear some comparison with the British pension reforms, including Australia, Canada, Denmark, Norway, Sweden, Poland, Uruguay and, the closest comparator, New Zealand. However, a systematic review of these case studies has revealed very little information about administrative burdens on employers<sup>44</sup>. Early evidence from New Zealand suggests that employers did not experience a significant administrative burden, with the most onerous tasks involving learning about the reforms and communicating to employees.

### **3.3.1 Stakeholder views**

The regulatory burden of the reforms is a concern for employers. As part of our consultation process we asked specifically for views on the administrative costs for employers and any ways in which these could be reduced.

Generally, employers are most concerned about the set-up costs associated with putting qualifying schemes in place, making changes to administrative systems, providing information to employees and so on. Employers are particularly concerned about the burdens of choosing a scheme, and being seen to provide advice to employees and the risk of litigation if they give the wrong advice or select a scheme that performs poorly.

Some stakeholders have also described the opt-out and refund processes, in particular, as clunky and burdensome. Another key area of concern is 'certification': the process by which employers can determine whether their existing scheme meets the quality requirements.

<sup>44</sup> Collard, S and Moore, N, 2010, "Review of international pension reform", Department for Work and Pensions Research Report No 663.

There are some concerns about ongoing processes in steady state, particularly around the burdens of re-enrolment and re-registration. Some employers also raised concerns about the administrative burden of processing employees on zero-hours contracts, since these individuals are likely to go in and out of pension saving as their earnings fluctuate. Unsurprisingly, employers have consistently said, both in consultation and in DWP's research, that a waiting period would help companies with high turnover by eliminating the costs of enrolling and un-enrolling significant numbers of employees every year.

Chapters 5 and 8 discuss the proposals for a waiting period and Chapter 6 discusses other suggested deregulatory changes.

### 3.3.2 Estimating the administrative costs for employers

The DWP have estimated the additional cost to employers of complying with the new duties. This work follows the standard cost model methodology recommended by the Better Regulation Executive. The employer administrative costs take into account the range of new activities employers will need to perform to fulfil their legal obligations. These can be categorised into four high level groups, which capture the processes described earlier: preparing for start-up; registration; enrolment; and collection and administration.

Tables 3.4 and 3.5 show the estimated administrative costs for employers in Year 1 and on an ongoing basis split by firm size and activity. Table 3.6 shows the administrative costs per person automatically enrolled by firm size. Year 1 costs for all firms are estimated at £444m, ongoing costs are estimated at £127m.

We are particularly concerned about the impact of the administrative burden on smaller employers because:

- There is a potentially high regulatory burden on the smallest employers. Very few of these smaller employers are currently providing workplace pensions and will not have experience of providing pension or the processes involved; there are fixed cost elements of meeting the new duties; and these employers are less likely to have a specific HR resource and are therefore more like to carry the administrative burden themselves, potentially creating a conflict with their focus on running their business successfully.
- While the vast majority of employers are small employers, they employ a relatively small proportion of total employees. Of the 19.2 million private sector employees, 2.3 million work for micro employers and around 300,000 work for single employee firms. This raises the question of whether the regulatory burden, in conjunction with the costs of ensuring compliance, are proportionate to the benefits generated.

As a consequence, we have considered the burden on smaller employers carefully: Section 3.5 looks further at the extent of regulatory burden in the context of the level of pension contributions generated; Chapters 5 and 8 examine whether smaller employers should be covered by new requirements; and Chapter 6 looks at how the regulatory burden on employers and particularly small employers might be eased.

**Table 3.4: Year 1 administrative costs split by firm size and activity (£m)**

Activity	Employer size number of employees						Total
	250+	50-249	20-49	5-19	2-4	1	
Prepare for start-up	38	38	15	74	68	24	257
Registration	0	1	1	3	9	2	15
Enrolment	34	11	8	12	9	3	76
Collection and Administration	5	7	8	26	37	12	96
<b>Total</b>	<b>77</b>	<b>57</b>	<b>32</b>	<b>114</b>	<b>123</b>	<b>41</b>	<b>444</b>

Source: Department for Work and Pensions modelling.

**Table 3.5: Ongoing administrative costs split by firm size and activity (£m)**

Activity	Employer size number of employees						Total
	250+	50-249	20-49	5-19	2-4	1	
Prepare for start-up	0	0	2	0	6	2	10
Registration	0	0	0	0	2	0	3
Enrolment	7	3	2	3	3	1	18
Collection and Administration	5	7	8	26	37	12	96
<b>Total</b>	<b>11</b>	<b>10</b>	<b>12</b>	<b>30</b>	<b>47</b>	<b>16</b>	<b>127</b>

Source: Department for Work and Pensions modelling.

**Table 3.6: Administrative costs per person automatically enrolled split by firm size**

Costs	Employer size number of employees						Total
	250+	50-249	20-49	5-19	2-4	1	
Number of Individuals enrolled	4,149	1,713	1,162	1,891	1,055	296	10,266
Year 1 £	19	33	27	61	116	140	43
Ongoing £ per year	3	6	10	16	45	53	12

Source: Department for Work and Pensions modelling.

## 3.4 Contribution costs for employers

### 3.4.1 Stakeholder views

Most employers accept the Pensions Commission case for the role of an employer contribution in addressing the problem of undersaving for retirement. DWP's research in 2006 reported that six in ten employers felt that a minimum employer contribution was a good idea<sup>45</sup> and, in the Association of Consulting Actuaries' 2010 survey of small and medium sized firms, less than two in ten respondents felt that the employer contribution should be reduced, with a quarter thinking the levels should be increased<sup>46</sup>.

<sup>45</sup> Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, "Employer attitudes to personal accounts: Report of a quantitative survey", DWP Research Report No 397.

<sup>46</sup> ACA, 2010, "Survey of smaller firms views on automatic enrolment and NEST."

### 3.4.2 Estimating contribution costs

Table 3.8 shows the additional costs needed to ensure all qualifying individuals receive the minimum three per cent employer contributions into their pension<sup>47</sup>. These figures represent the amount that employers will have to contribute to their employees' pensions, excluding their existing contributions bill for any pension provision they may have already. Thus, this takes account of any increase in contribution rates and increases in take up rate due to automatic enrolment.

One might have expected the contribution costs to be close to three per cent of labour costs. However, on closer inspection this is not so. First, these figures exclude the cost of existing pension contributions – a substantial proportion of employees are already members of a pension scheme and so there is no increase in costs for those jobholders. Second, the employer contribution is based on a band of earnings, whereas labour costs include all pay plus social security contributions. Finally, these figures are based on an assumption that around a quarter of employees will opt out of workplace pension saving once automatically enrolled. These three factors combine to produce the relatively low labour cost estimates seen in Table 3.7.

**Table 3.7: Additional estimated costs to employers of minimum contributions, once contributions have been fully phased in**

Number of employees	Contribution cost estimate £m	Percentage of labour cost percentage
1	80	} 0.8
2 to 4	310	
5 to 19	580	} 0.8
20 to 49	440	
50 to 249	590	0.6
250 to 499	230	} 0.4
500+	1,020	
<b>Total</b>	<b>3,240</b>	<b>0.5</b>

Source: Department for Work and Pensions modelling.

### 3.4.3 How employers plan to absorb costs associated with pension reform

Contribution costs represent an additional labour cost to employers. In the long term, we would expect this to be reflected in lower general wages than might otherwise have been the case. This would mean that individuals who choose to opt out of pension saving would be comparatively worse off, since their lower wages are not compensated by the three per cent employer pension contribution.

<sup>47</sup> The costs are based upon the current UK pension landscape, which describes current pension provision and those individuals who will be automatically enrolled as a result of the reforms. The landscape is generated using: the Employer Pension Provision Survey 2009; the Annual Survey of Hours and Earnings 2009; the Employer Attitudes Survey 2007; and the Individual Attitude Survey 2009.

It is less clear in the short-term what employers will do to cope with contribution costs. This will largely depend on the anticipated scale of the additional costs. Employers who already contribute three per cent or more and have high levels of take up will face proportionally very low additional costs, since automatic enrolment will not increase the number of members by very much. By contrast, employers who make no contributions currently or have very low levels of take up will have to start paying contributions for a large proportion of their workforce for the first time, incurring much higher proportional costs. The options they have available to them for coping with these costs will depend on a number of other factors:

- The prevalence of existing pension provision, reducing the additional administrative and automatic enrolment costs on the reform.
- The ability of firms to be able to pass costs on to employees through lower wage settlements. Firms with a more elastic labour supply curve will find it easier to pass on costs through lower wages than those with a rigid labour supply and therefore face less pressure from the reforms.
- The ability of firms to pass on the costs to consumers through higher prices.
- The ability of firms to absorb the costs into their profit functions.
- The ability of firms to manage the costs of reforms through increased sales.

When asked in a 2009 DWP survey<sup>48</sup>, three in ten employers (31 per cent) said they planned to absorb costs through profits/overheads, compared with two in ten (18 per cent) through wages and fifteen per cent through increased pricing. A further sixteen per cent felt they would have to reduce or restructure their workforce in order to counter the costs of the reforms. Employers' proposed strategies were based on considerations of complex trade-offs around competition, how highly unionised their workforce was, financial margins and pressure from shareholders to maintain profits. Underpinning all of this, employers felt that the economic climate and state of the labour market at the time would significantly affect their decision making. Ultimately, we will only know the extent to which employers used differing strategies by monitoring and evaluation of actual behaviours<sup>49</sup>.

#### 3.4.4 “Levelling down”

An alternative strategy for employers with existing high quality provision is to reduce their pension contributions across the board to offset the costs of higher membership resulting from automatic enrolment. Alternatively, employers may take the less drastic route of maintaining existing members' contributions, but offering only the minimum required to new members at the point of automatic enrolment. Workforce churn over time, combined with such a policy, would mean that an increasing proportion of individuals saving in workplace schemes would receive only a three per cent contribution from their employer. This risk of “levelling down” has consistently been raised as a concern by consumer groups and by the pensions industry.

48 Source: Bewley, H and Forth, J, 2010, “Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey”, Department for Work and Pensions Research Report No 683.

49 Treadwell, L and Thomas, A, 2008, “Understanding employers' responses to the workplace pension reforms: Report of a qualitative study”, Department for Work and Pensions Research Report No 547.

We cannot know for certain how likely this might be, since a range of factors will influence employers' decision-making. It is difficult to predict any type of future behaviour, but nevertheless a wide range of interested parties, including DWP, have carried out surveys in an attempt to predict the likely extent of levelling down of existing pension provision<sup>50</sup>.

Some of the earliest research evidence bears out the general pessimism: the Association of Consulting Actuaries reported that seven in ten employers expect there to be widespread levelling down<sup>51</sup>, and Deloitte's modelling predicted eight in ten employers would level down<sup>52</sup>. However, taken as a whole, the bulk of evidence suggests only limited reductions in pension contributions as a result of the reforms. Surveys by Fidelity<sup>53</sup>, Capita Hartshead<sup>54</sup> and the CBI<sup>55</sup> consistently report that around seven in ten employers are not planning to revise or reduce their current levels of provision, and the National Association of Pension Funds found only three per cent of employers planning to reduce contributions for existing members<sup>56</sup>. DWP's systematic survey of UK employers in 2009 reported that more than nine in ten employers already contributing three per cent or more plan to maintain or increase these contributions for current members, and eight in ten plan to extend their existing provision to new members<sup>57</sup>. The Association of Consulting Actuaries' 2010 survey of small and medium sized employers was slightly more pessimistic, with three in ten respondents indicating they were likely or highly likely to review their existing benefits, albeit only 11 per cent explicitly said they would level down their existing provision as a direct result of automatic enrolment<sup>58</sup>.

From a purely economic standpoint, this is surprising. However, the majority of employers offering high quality pension provision are ideologically committed to maintaining this, either for paternalistic reasons, or as a crucial tool in recruiting and retaining employees. And whilst we should be cautious in interpreting how far stated intentions will translate into real behaviour, what little evidence there is generally suggests a reasonable degree of correlation between employers' given views and their actions<sup>59</sup>. At the same time, employers' stated preference for maintaining their pension provision will be tempered by pragmatic considerations of economic circumstances at the time and the feasibility of absorbing costs in other ways<sup>60</sup>.

50 These surveys use a variety of methods, ranging from quick online surveys of a handful of an organisation's members to large-scale systematic sampling of the full employer population. Equally, the types of questions asked and the respondent's levels of understanding of the reforms varied widely. We must thus bear in mind the range in survey reliability and validity when interpreting the findings.

51 ACA, 2007, "Pension trends survey report."

52 Deloitte, 2006: "Pension reform in the workplace."

53 Fidelity research, 2008: "Corporate Commitment to Pension Provision."

54 Capita Hartshead, 2008: "Fifteenth Annual Pension Scheme Administration Survey."

55 CBI, 2009: "A view from the top: The 2009 CBI pensions survey."

56 NAPF, 2008: "Workplace Pensions: The Personnel Perspective."

57 Bewley, H and Forth, J, 2010, "Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey", Department for Work and Pensions Research Report No 683.

58 ACA, 2010: "Survey of smaller firms views on automatic enrolment and NEST."

59 Hayward, B, Fong, B and Thornton, A, "The Third Work-Life Balance Employer Survey", Department for Business Enterprise and Regulatory Reform, Employment Relations Research Series No 86. This survey explored relationships between employers' attitudes to work/life balance and the degree to which they had implemented flexible working practices for employees.

60 Tredwell, L and Thomas, A, 2008, "Understanding employers' likely responses to the workplace pension reforms 2007: Report of a qualitative study", DWP report number 547.

A second risk factor for possible “levelling down” is the uncertainty created by the new definition of qualifying earnings, since this does not align with current definitions of pensionable pay. Employers who are unsure whether their existing arrangements are equivalent to the definition of qualifying earnings (eight per cent total contributions on a band of total earnings) may simply decide to re-calculate their contributions based on the minimum qualifying earnings requirements, to be certain they are meeting the duty for all employees. This would entail a calculation based on a lower level of earnings for some 90% of employees. We are uncertain how significant this risk is, but a simple certification model should help mitigate against this.

## 3.5 Ensuring employer compliance with the reforms

In addition to the direct costs to business of contributions and administration, one of the key costs associated with the reforms is the cost of ensuring compliance with the new duties. The benefit to individuals of automatic enrolment is directly dependent upon employers meeting their duties. Given that these duties are new to all employers, and that many employers will be providing pensions for the first time, an effective compliance regime is essential.

The greatest risk to the compliance regime is that large numbers of micro employers will fail to meet their duties, either through poor understanding of the duties or through wilful non-compliance. The smallest employers are identifiably at the highest risk of non-compliance, looking at their attitudes to pension provision, levels of understanding and self-reported risk of failing to meet the duties on time. This potentially presents a significant concern, given the very large numbers of very small employers, and thus the potentially high costs of following up and enforcing compliance with this group.

### 3.5.1 The role of The Pensions Regulator

The Pensions Regulator will have a new role in ensuring compliance with the automatic enrolment regime. The precise details of how The Pensions Regulator will apply enforcement will be subject to their discretion at the time, within their powers. However, the overall compliance approach is to educate employers about their responsibilities and encourage and assist them to comply with the legislative requirements. Enforcement, where necessary, will proceed from initial reminders through formal notices to penalties.

In the first instance, The Pensions Regulator will produce guidance for employers, many of whom will have no previous experience of pension provision, on how to comply with their new duties. It will also write to employers twice in the run-up to the employer’s staging date, alerting them to the need to take appropriate action in good time. The Pensions Regulator will provide an on-line registration service for employers, process registrations, deal with queries relating to registration, and identify and pursue employers who have failed to register.

The Pensions Regulator will take a graduated, proportionate and risk-based approach to enforcement. It will investigate complaints from jobholders, scheme members, and trustees and administrators of pension schemes, making initial telephone or written contact with non-compliant employers, issuing compliance notices and, where necessary, proceeding to impose fixed and/or escalating penalties. The Pensions Regulator has the power, where appropriate, to inspect premises and require production of documents relevant to its investigations. It can institute criminal proceedings in the case of serious and persistent non-compliance. Once the reforms are established, The Pensions Regulator will consider carrying out pro-active checks to check compliance across employer sectors.

### 3.6 Evaluating the regulatory burden

The overall cost of the reforms relating to employers comprise three elements: the administrative burden on employers of complying with the reforms, the cost to The Pensions Regulator of enforcing employer compliance and the cost of NEST to ensure all employers have access to a suitable workplace pension scheme.

Table 3.8 compares the total of these costs with the estimated level of pension contributions generated as a result of the reforms. The total additional pension contributions across all employers over the implementation period are estimated to be £17,110m, while the total costs associated with administering this additional saving is £1,600m, or around 9 per cent of contribution costs. In steady state (2018/19), additional pension contributions are estimated to be £11,400m a year, while the total cost associated with administering additional saving is £250m a year, or around two per cent of contribution costs.

For micro employers, however, additional pension contributions over the implementation period are estimated to be £1,670m and the cost associated with administering this additional saving is £530m, or around 32 per cent. In steady state (2018/19), additional pension contributions are estimated to be £1,350m a year. The cost associated with administering this additional saving is £130m a year, or around 10 per cent. This confirms our concerns about the impact and proportionality of the administrative costs of applying the new duties to smaller employers, a theme we explore further in Chapters 5, 6 and 8.

**Table 3.8: Pension contributions and total costs by firm size**

	During implementation (total costs up to 2018/19)		In steady state (annual costs from 2018/19)	
	All employers	Micro firms	All employers	Micro firms
	Total pension contributions £m	17,110	1,670	11,400
Total administration, NEST, compliance £m	1,600	530	250	130
Percentage	9	32	2	10

Source: Department for Work and Pensions modelling.

In evaluating the regulatory burden of the pension reforms, it is important to consider the context of the full range of regulations imposed by Government on business, to examine the cumulative impact for employers. These may affect their ability to cope with the burdens through further cost increases. Wage freezes due to low inflation, other new burdens for businesses alongside the current economic climate may make it difficult for firms to pass on the costs of these reforms as easily as they otherwise could. The Government is currently reviewing all legislation inherited from the previous Government that has not yet been implemented. Until these regulations have been reviewed, it is not possible to say what other regulations will be implemented between now and 2012.

### **3.7 Conclusions**

Most employers accept the Pensions Commission case for the need to address under-saving for retirement and recognise the role of an employer contribution in pension reform. Employers are more critical of the costs associated with the administrative processes required under pension reform. We want to minimise the administrative costs as far as possible, and ensure that they are proportionate to the benefits of automatic enrolment in terms of the additional pension saving generated, particularly for micro employers who represent 66 per cent of all employers but employ only 12 per cent of the workforce.

We can divide employers into five broad groups, based on the degree of change they will have to make to their existing pension arrangements in response to the reforms. The first two of these five groups of employers will face the least change because they already provide good quality workplace pensions. They are familiar with making decisions about pension provision, and can be confident that they already contribute enough to meet minimum quality requirements. The other three groups of employers have no or limited experience of pension provision. Where they do provide a pension, it may not meet the quality requirements under the reform.

Costs to employers can be divided into two portions. The contribution costs are the costs to the employer of providing the three per cent minimum contribution to members; this represents a transfer to the employee, rather than a pure cost in economic terms. By contrast, administrative costs are the cost to the employer of setting up a pension scheme, automatically enrolling employees, calculating and deducting contributions, and registering with the Pensions Regulator. These costs represent a true economic cost, and it is these costs that we are keen to minimise as far as possible.

We pick up these themes further in Chapters 5, 6 and 8.