



Chapter 1: Encouraging and enabling private pension saving



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Summary

Millions of people are not currently saving enough to meet their expectations for income once they retire. There are persistent and powerful barriers to people taking the long-term savings decisions that would be needed to address this problem. These include inertia, financial myopia, the cost of pension saving and the complexity of the decisions involved.

The Government will respond to that challenge with a radical reform of private pension saving in the UK.

First and foremost, we need to tackle at source these barriers to saving, to create an environment in which individuals take personal responsibility for ensuring that their aspirations for retirement income are met.

In order to achieve this, we will:

- introduce a new pension saving scheme of **low-cost, portable personal accounts**, making private saving truly accessible for all;
- introduce **automatic enrolment** into a private pension for all employees, to maximise coverage and combat savings inertia;
- set a **national minimum employer contribution of 3 per cent**, between earnings of around £5,000 and £33,000 a year; and
- set a **minimum overall level of contribution of 8 per cent** for the personal accounts of employees and encourage additional contributions from employees.

These reforms are a key part of our strategy to meet the five tests for pension reform. In particular they will help to promote **personal responsibility**, by helping to overcome the barriers to saving; **simplify** the system for individuals, by clarifying the savings decisions they need to take; and make the system **fair**, by ensuring access to high-quality, low-cost provision for all.

The challenges facing the pensions system

Current pensioners are relatively well provided for

- 1.1 As the Pensions Commission made clear, private pension incomes are at an all-time high and, for the first time ever in a period of economic growth, pensioners are less likely to be at risk of poverty than younger people.¹
- 1.2 A key driver of improvements in pensioners' incomes has been private pension coverage and generosity. Recent retirees have benefited from relatively generous defined benefit (DB) occupational pensions and also from historically good rates of return in defined contribution (DC) pensions.
- 1.3 Other factors have also boosted the income and assets of current pensioners. The State Earnings-Related Pension Scheme (SERPS) was introduced in 1978, and people retiring today are benefiting from its most generous provision. In addition, the value of housing wealth has doubled as a percentage of GDP since 1980, and home ownership among recently retired people has increased from under 50 per cent to approaching 80 per cent since 1981.²

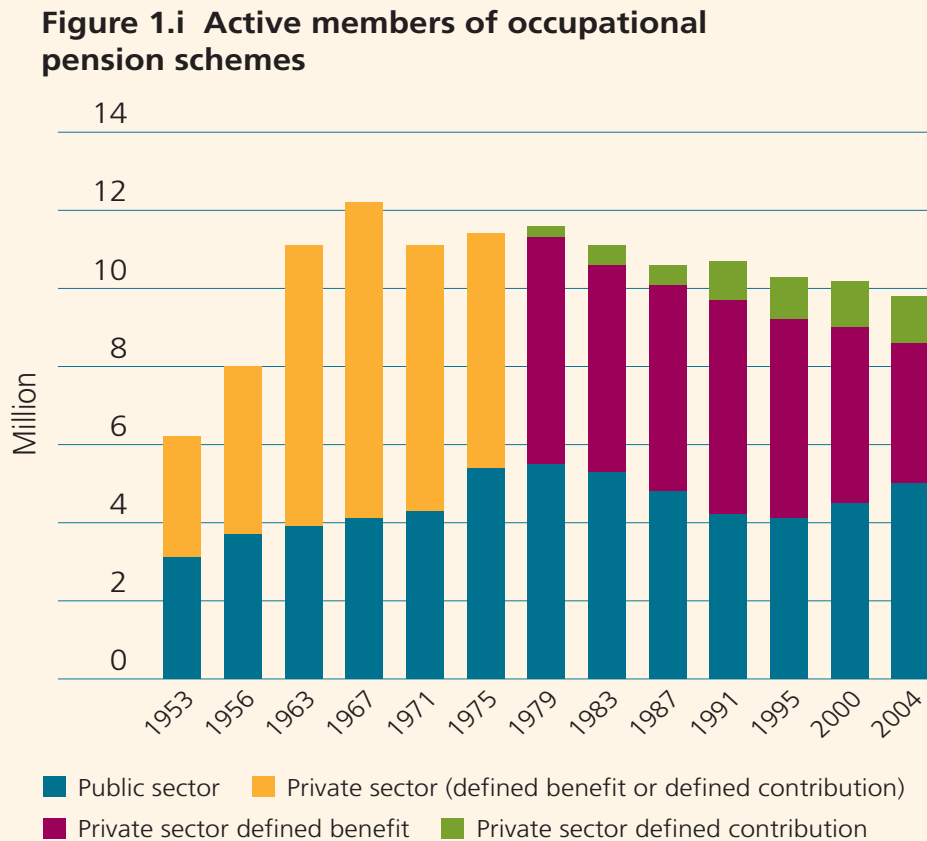
Recent trends in private pension provision

- 1.4 But the Pensions Commission also made clear that private pension saving is in decline, and that this decline has been an underlying trend for a number of years. This is despite household net wealth having risen by around 60 per cent in real terms since 1997. Even at the peak of private saving, many people were not making sufficient provision for their retirement. But while there were 12.2 million active members of occupational schemes in 1967, the number has been decreasing so that, in 2004, there were around 9.8 million members remaining, of which over half were in the public sector.³

¹ *Pensioner Income Series*, DWP.

² *Economic and fiscal strategy report and Financial statement and budget report*, March 2006.

³ GAD, *Occupational Pension Schemes 2004*.



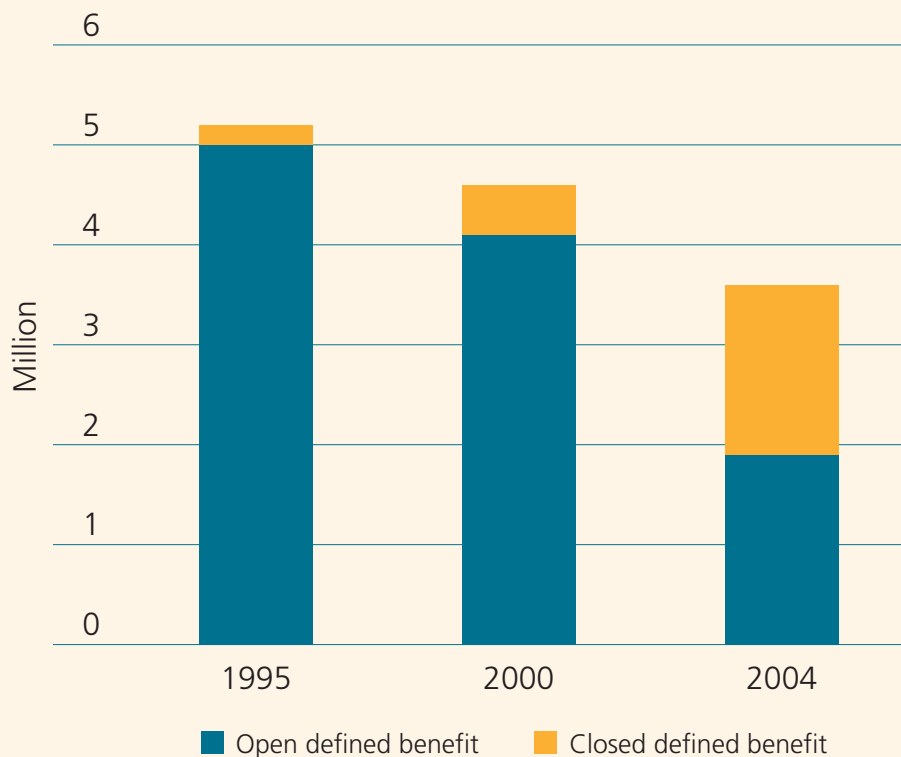
Source: Government Actuary's Department's Occupational pension schemes survey

Notes: The 2004 split between private and public sectors is not perfectly comparable with splits in earlier years, since from 2000 onwards the public sector figures have included only those members who are in public service schemes. It follows that, from 2000 onwards, figures for the private sector also include members in the wider public sector (such as the Post Office and the BBC).

- 1.5 Contributions to occupational pensions have fallen from above 3 per cent of GDP in the early 1980s to less than 2 per cent in 2002. And the proportion of private sector employees participating in occupational schemes has fallen from around 37 per cent in 1991 to around 26 per cent in 2004.⁴
- 1.6 There has also been a recent acceleration of some trends. In particular, recent years have seen the closure of many DB occupational schemes, although some of these have been replaced with DC schemes. This has led to a rapid fall in the number of active members of DB schemes.

⁴ Pensions Commission, 2004, *Pensions: challenges and choices: The First Report of the Pensions Commission*.

Figure 1.ii Active members of private sector defined benefit pension schemes by scheme status



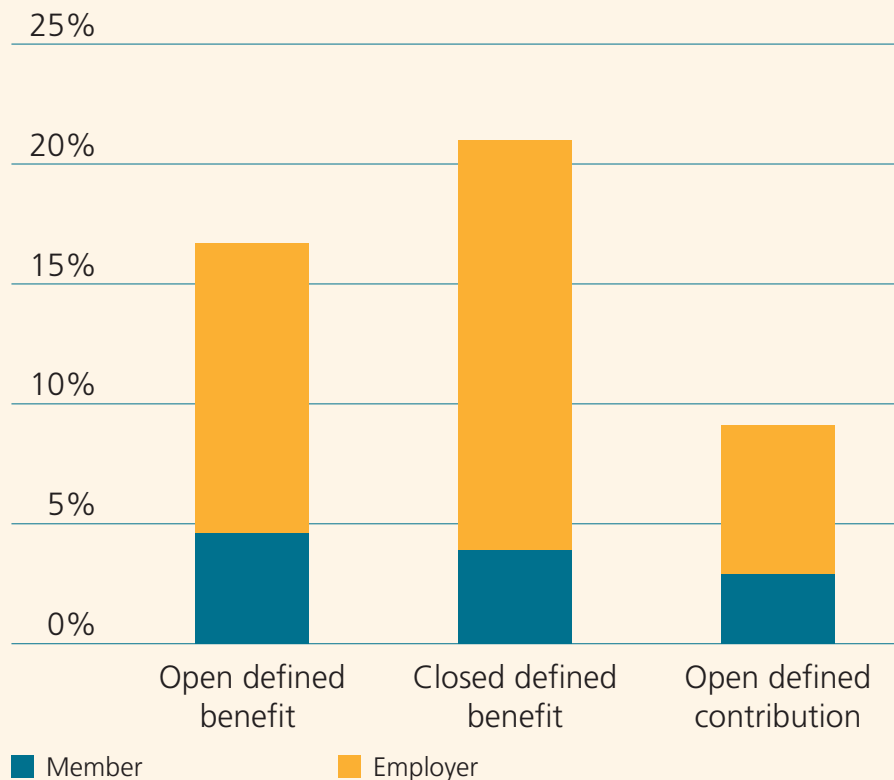
Source: Government Actuary's Department's Occupational pension schemes survey

- 1.7 DB schemes are those that offer a pension based on a certain formula (usually years worked and final salary). They are not necessarily better than DC schemes, where the pension depends on the performance of underlying investments such as shares. For many people the greater flexibility of DC provision better matches the greater mobility in the labour market and the increase in the number of jobs people may expect to do during their lives.
- 1.8 However, a shift from DB to DC provision is often associated with a cut in average pension contribution rates, particularly those made by the employer. This means that people are likely to end up with significantly lower pensions when they come to retire. On average, total contributions into DB schemes are currently around 19 per cent of earnings, compared to 9 per cent for DC schemes.⁵ Figure 1.iii shows average contributions into DB occupational pensions (split between open and closed schemes) and DC occupational pensions. But a simple comparison of contributions to DB and DC schemes is not appropriate, as contribution levels to DB schemes can vary over

⁵ GAD, *Occupational pension schemes 2004*. The recently published *Employers' pension provision survey 2005* has similar findings for occupational schemes (with ten or more members) – in 2005, employers contributed 10 per cent to open DB schemes on average (median) and only 5 per cent to open DC schemes; employees contributed on average 6.9 per cent to open DB schemes and 5 per cent to open DC schemes.

time and DC schemes are more likely to be contracted in (so the pension is received in addition to State Second Pension rather than instead of State Second Pension).

Figure 1.iii Contribution rates for occupational pension schemes, 2004



Source: Government Actuary's Department's Occupational pension schemes survey

Notes: Data covers private sector schemes, including schemes where standard contributions were zero.

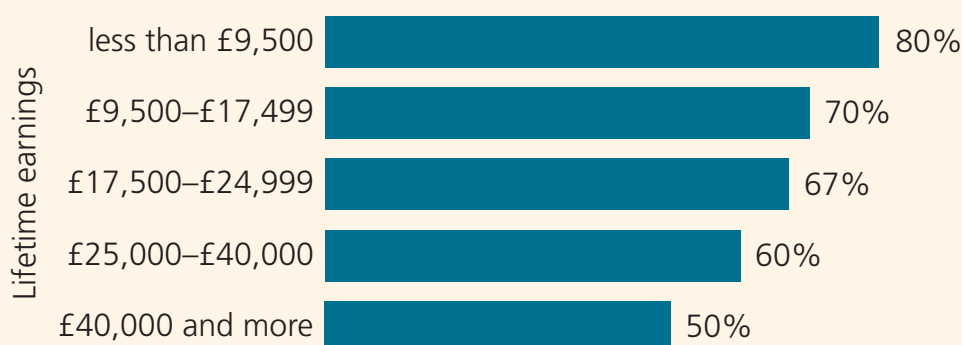
Weighted average contribution rates, across all schemes with 12 or more members, are calculated on the basis of the number of active members.

Undersaving for retirement

- 1.9 Many people are not saving enough to generate the level of income they will want in retirement. A number of studies have used a range of data to estimate the number of people who are not saving enough to reach a level of income they might consider adequate.
- 1.10 Measures of retirement income adequacy are based on replacement rates, which measure people's retirement income as a percentage of their income in work. Typically people are content with a modest fall in income at retirement because they tend to see a fall in the cost of living (for example, travel to work and housing costs). However,

few people are likely to be content with a retirement income that is dramatically less than that which they had while working. While there is scope for debate around the appropriate target replacement rates, the Pensions Commission proposed a 'sliding scale' of 80 per cent for the lowest earners, to two-thirds for average earners and 50 per cent for the highest earners.⁶

Figure 1.iv Pensions Commission benchmark replacement rate range



Source: Pensions Commission First Report

1.11 Estimates of the current level of undersaving for retirement are difficult to construct because they rely on poor data and there are measurement difficulties, such as whether to measure income at a household or individual level and whether to include estimates of non-pension financial assets and inheritance. However, key recent studies find the following.

- New information has recently become available from the English Longitudinal Study of Ageing.⁷ For the first time this allows us to use comprehensive data on people's accrued pension rights and non-pension financial assets (though it is available only for people aged 50 and over). Using this data, it is possible to estimate that, based on the Pensions Commission's replacement rate benchmarks, there are 7 million people undersaving for retirement. However, there are questions about whether individuals would access some of these non-pension financial assets to create a retirement income and whether the trends for older workers will persist for younger generations.

⁶ These replacement rates are based on gross income. Replacement rates based on net income would be higher.

⁷ IFS, 2005, *Prepared for retirement? The adequacy and distribution of retirement resources in England*, with DWP internal adjustments. More detail on the figures is provided in Annex A.

- In 2002⁸ the Department for Work and Pensions (DWP) estimated that up to 3 million people were seriously undersaving for their retirement or planning to retire too soon, based on a 50 per cent desired replacement rate. DWP found that a further 5 to 10 million may want to consider saving more and/or working longer, depending on their expectations for retirement, based on a two-thirds replacement rate.
- The Pensions Commission's first report⁹ argued that 9.6 to 12 million people are not saving enough for retirement. This was based on the replacement rate benchmarks discussed above.
- The Association of British Insurers (ABI)¹⁰ has estimated that 12.1 million people are undersaving for retirement, also based on the Pensions Commission's replacement rate benchmarks.

1.12 Although estimates vary, the story is clear: many millions of people are not saving enough to provide retirement incomes they are likely to consider adequate. These people will need to save more or will approach retirement faced with the choice of an income they will consider inadequate or having to work longer than they had planned.

Reforms since 1997

1.13 A number of reforms since 1997 have sought to address the problem of undersaving for retirement.

Stakeholder pensions

1.14 In April 2001, stakeholder pensions introduced a simple, flexible and low-cost product into the personal pensions market. They have improved workplace access to pensions where an employer-based scheme is not available.

1.15 Stakeholder pensions have a limit on annual management charges and they are flexible and portable. This means that individuals can contribute intermittently if their circumstances require it, and change provider, without fear that they will have to pay penalties or see their contributions swallowed up by high charges. They are available to the self-employed and those not in paid employment (such as carers), as well as to employees.

1.16 Employers with five or more employees are required to provide their workforce with access to a stakeholder pension scheme unless they already offer an occupational pension scheme to the whole of their workforce or pay employer contributions of at least 3 per cent of basic earnings into personal pensions.

⁸ DWP, 2002, *Simplicity, security and choice: Working and saving for retirement*.

⁹ Pensions Commission, 2004, *Pensions: challenges and choices: The First Report of the Pensions Commission*.

¹⁰ ABI, 2005, *The state of the nation's saving*.

- 1.17 Over 2.7 million stakeholder pensions have been sold since their introduction in April 2001,¹¹ the majority to their target group of moderate earners. Of those stakeholder pension plans that received a contribution in the 2003/04 tax year, over three-quarters were for people earning under £30,000 a year and around two-thirds were for people earning less than £20,000 a year. Total contributions to stakeholder pension schemes in the 2004/05 tax year were around £2.4 billion.
- 1.18 The low charges in stakeholder pensions have also helped to exert downward pressure on personal pension charges in general. The impact of this has been dramatic: charges on personal pensions fell by around a third between 1999 and 2001 to around the stakeholder pension charge cap level.¹²

Information and education

- 1.19 Since 2002, the Informed Choice programme has looked at ways to raise awareness and understanding of retirement provision, and to promote individual responsibility for retirement planning.
- 1.20 To ensure that everyone has timely information about their own circumstances, we have introduced a range of pension forecasts as part of this programme. The forecasts give individuals an understanding of the income they are likely to receive in retirement based on their National Insurance contributions or credits. They are supplemented by leaflets that set out options for improving their position – such as working longer and deferring receipt of their pensions or making additional contributions.
- 1.21 DWP now issues the following types of forecasts:
- Combined Pension Forecasts (CPFs): Issued in partnership with employers and pension providers, CPFs show State Pension information alongside a forecast of an individual's current private pension. By the end of March 2006, over 2,700 employers or pension providers had signed up to issue CPFs and over 6.3 million CPFs had been produced.
 - Individual Pension Forecasts (IPFs): IPFs are tailored to an individual's circumstances, taking into account factors such as marital status, current employment status, or any periods spent abroad. IPFs can also address the impact of options such as working longer, going abroad or getting married or divorced. Over 7 million IPFs had been issued by the end of March 2006.
 - Real-Time Pension Forecasts: In October 2004 we launched a service whereby individuals can contact DWP electronically to obtain an online IPF. DWP had received more than 107,000 requests by the end of March 2006.

¹¹ Source: ABI.

¹² Source: Financial Services Authority (FSA).

- Automatic State Pension Forecasts (APFs): First issued in 2003, APFs are unsolicited forecasts sent by DWP to all working-age people who have not received any other type of forecast in the previous 12 months. By the end of March 2006, over 12 million APFs had been issued.

Tax simplification and the Finance Act 2004

- 1.22 The Government provides generous tax relief to encourage people to save for an income in retirement. From 6 April 2006 (A-Day), the many existing sets of rules governing the taxation of pensions were replaced with a single, unified regime.
- 1.23 The new regime introduced simplified rules around the tax treatment of pensions, offering less complex and more flexible retirement arrangements for individuals and employers.
- 1.24 There is now no limit on the amount of pension saving an individual can build up in a pension scheme or the number of pension schemes they can save in – although there are limits on the amount of tax relief individuals can get.
- 1.25 The two key features of the new regime are a single lifetime allowance and an annual allowance for the amount of tax-privileged savings. The single lifetime allowance is currently set at £1.5 million (rising to £1.8 million by 2010/11 and to be reviewed subsequently). A tax charge is made where an individual has an excess above the £1.5 million allowance. Individuals can also get tax relief on contributions up to 100 per cent of annual earnings up to the annual allowance, currently £215,000 (rising to £255,000 by 2010/11 and to be reviewed thereafter).
- 1.26 Additionally, if scheme rules allow, individuals can take up to 25 per cent of their pension fund as a tax-free lump sum.

Member protection

- 1.27 We recognise that people will only save if they have confidence that when they have done so the pension will be there when they need it. The Government has worked to ensure that the environment is safe enough to give people the confidence they need.

The Pension Protection Fund

- 1.28 The Pensions Act 2004 established the Pension Protection Fund (PPF) to protect members of final salary pension schemes by paying compensation should the employer become insolvent and the pension scheme underfunded. It also pays compensation to pension schemes that are unable to meet their obligations due to fraud. The PPF went live on 6 April 2005 and is funded through compulsory levies imposed on schemes that are eligible to apply for PPF assistance.

1.29 To reduce cross-subsidy and promote fairness, the PPF charges a risk-based levy, so that schemes that pose a higher risk pay more for the PPF compensation cover, and costs are kept down for good employers with well-funded schemes. The Financial Assistance Scheme will help some of those who lost out before the PPF was established.

The Pensions Regulator

1.30 The Pensions Act 2004 also established a new regulatory body for work-based pensions, The Pensions Regulator (TPR). The new regulator has a defined set of statutory objectives:

- to protect the benefits of members of work-based pension schemes;
- to promote good administration of work-based pension schemes; and
- to reduce the risk of situations arising that may lead to claims for compensation from the PPF.

1.31 TPR was developed to take a proactive, risk-focused approach to regulation. Resources are concentrated on schemes where the greatest risk to the security of members' benefits is identified, so well-run schemes have a lighter regulatory burden than before. It also provides practical support for the pensions community.

Remaining problems

1.32 These reforms have clearly changed the pensions landscape and introduced choice and flexibility for pension schemes, but the issue of undersaving for retirement among today's workers still remains.

Unclear incentives to save

1.33 Pension Credit has successfully boosted the income of millions of pensioners and has also ensured that they are better off for having saved. In addition, it has improved incentives to save for some people. For example, research commissioned by DWP¹³ estimated that the introduction of Pension Credit led those on low to middle incomes (comprising 12 per cent of the population) to have better incentives to save and to work longer.

¹³ National Institute for Economic and Social Research, 2005, *The effects of means-testing pensions on savings and retirement*.

- 1.34 However, the way in which elements of the State Pension and Pension Credit system are updated means that the coverage of Pension Credit is spreading. If current indexation arrangements continued, the proportion of pensioner households entitled to Pension Credit would increase from around 45 per cent today to around 70 per cent by 2050. This is discussed further in Chapter 3.
- 1.35 The potential future spread of Pension Credit could reduce incentives to save for some people. However, it has never been the Government's intention to move over the long term towards a system where a significant majority of pensioners are entitled to Pension Credit.
- 1.36 People are less likely to engage with long-term financial planning if the decisions they need to make and the system within which they make them are overly complex. The Pensions Commission concluded that the UK pension system is the most complex in the world. A recent survey found that two-thirds of people agreed – they find all pensions confusing.¹⁴ This complexity is likely to further affect undersaving for retirement.
- 1.37 There is relatively low awareness of the financial incentives to save in a pension. In the same survey, only a quarter of people (26 per cent) spontaneously mentioned tax relief as an advantage of pensions, and even when prompted, only 43 per cent were aware of the tax benefits of saving in a pension.

Understanding undersaving for retirement

- 1.38 Behavioural economists¹⁵ have conducted research on how people make financial decisions, including why people may not join a pension even when it is in their interests to do so. Traditional economics suggests that people make decisions based on a rational assessment of the costs and benefits to themselves. However, in reality many people find pensions difficult and complicated, and have a tendency to disengage from savings decisions. Even though most people realise they need to save for retirement, for a number of reasons many never get round to doing it. We know that the difficulty of making financial decisions often leads to individuals not acting at all. Box 1a explains some of the reasons why people may not join a pension.

¹⁴ Marketing Sciences Ltd, *Retirement planning monitor 2005*.

¹⁵ Notably Choi, Laibson, Madrian, Thaler and Benartzi.

Box 1a: Reasons for undersaving for retirement

Conventional economics suggests that people will try to smooth their spending over their lifetime. Thus, when people are young, they may choose to borrow money to fund their education or to buy a house, spending more than their income; as they get older and their income increases, they can pay off their debts and start to save, so spending less than they earn. However, actual spending tends to track income more closely than these theories would suggest.

Behavioural economics is the combination of psychology and economics, and helps to explain people's decision making. It has identified a number of reasons why people do not save for retirement, even when it is their interest to do so.

People may realise they should save for retirement but lack the willpower to change their behaviour appropriately. Inertia often leads people to follow the path of least resistance in decision making, making the easiest rather than necessarily the best decision, and procrastination can lead to them not making any decision at all.

In addition, people often live for today and struggle to see what their future needs might be. When presented with the option of having money now or more money in the future, people frequently choose to take the money now, even though they would be better off if they waited. This is reinforced by the fact that people often don't understand that inflation can erode the value of any money they have 'under the mattress'. This behaviour is influenced by aversion to losses, since people are often only willing to accept a loss to their income when the potential gains are very high and they feel losses more intensely than they feel gains.

- 1.39 The FSA's baseline survey of financial capability in the UK¹⁶ shows that many people are failing to plan ahead adequately for their retirement or for an unexpected expense or drop in income. For example, 37 per cent of people who said the State Pension would not provide them with the standard of living they hope for in retirement had no additional pension saving. And 39 per cent of people say they tend to live for today and let tomorrow take care of itself. However, even today when pensioner incomes are historically high, 21 per cent of people who have already retired do not find their income sufficient to give them the standard of living they hoped to have.

¹⁶ Atkinson A, McKay S, Kempson K and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, FSA Consumer Research 47.

High costs of delivering to those on low and moderate incomes

- 1.40 The fact that pensions need to be sold in a regulated market to protect consumers has led to a relatively expensive sales and marketing process for personal pensions.¹⁷ The Pensions Commission's research suggests that it costs around £800 to sell a personal pension to somebody working for a medium-sized employer. In addition, consumers often do not persist in making pension contributions for long, even once they have begun making them. The Pensions Commission found that, on average, consumers persist in saving for only around five years.
- 1.41 This combination of high up-front costs and non-persistence means that providers have a relatively short period in which to recoup relatively large sales costs. This has two effects on consumers.
- 1.42 **Firstly**, it leads to relatively high charges. Although the cost of saving in a personal pension has fallen considerably with the introduction of stakeholder pensions, it remains high compared with most occupational pensions. Few personal pensions sold to individuals have charges significantly below the stakeholder charge cap (1.5 per cent per year of funds under management, falling to 1 per cent after ten years).
- 1.43 By contrast, many occupational pensions and some group personal pensions are able to achieve administration charges equivalent to around 0.3–0.5 per cent or less. The impact that this can have on the size of someone's pension fund is considerable. Someone saving 8 per cent of median earnings for 40 years at the higher level of charge might expect to have a pension fund on retirement worth around 20 per cent less than an equivalent person saving at the lower level.
- 1.44 **Secondly**, it means that it is more economic for providers to sell to some consumers than others. Higher earners, who will have more funds in the scheme generating higher revenue, or those who work for larger employers, where providers can achieve sales and marketing economies of scale, are more attractive. The financial services industry does not generally seek to sell personal pensions to low to moderate earners, particularly if they work for smaller employers, because it is not economic to do so.
- 1.45 Further reform is needed to tackle the problem of undersaving for retirement, reverse the decline of private pension provision and overcome these barriers.

¹⁷ Pickering A, 2006, *A simpler way to better pensions: An independent report*.

Personal accounts: a low-cost savings scheme

- 1.46 To address the problem of undersaving for retirement, and in line with the Pensions Commission's recommendation, the Government proposes in 2012 to introduce a new, low-cost scheme of personal accounts for those people currently without access to adequate pension savings. Eligible employees will be automatically enrolled into the new scheme and, along with their employers and the State, will make contributions into the scheme on a DC basis. Individuals will have appropriate levels of choice over how to invest their funds. The accounts will be portable between employers and between periods of employment, self-employment and economic inactivity.
- 1.47 The new scheme will:
- significantly increase the number of people currently saving for retirement; and
 - have low charges so that individuals keep more of their savings.
- 1.48 The key features of the scheme will be:
- an organisational structure that ensures **low charges** and **good-quality service** for individuals;
 - **automatic enrolment** for all eligible employees but with the freedom to opt out;
 - a **minimum overall level of contribution** from employers, employees and the government, to promote a minimum level of pension saving, with people encouraged to contribute more;
 - a **national minimum employer contribution**, increasing incentives to save;
 - **opt-in access** available to, among others, the self-employed and those not currently in paid work; and
 - **portable and flexible accounts**, to fit in with modern life and the greater likelihood of people moving between jobs.
- 1.49 Together these measures will provide individuals with a low-cost means of building private retirement income in addition to their state pension entitlement, with a presumption to save for many. The following sections discuss the key elements of our reforms in more detail and indicate areas where we intend to consult further.

Box 1b: How many people will be in the personal accounts scheme?

Around 10 million employees will be eligible for automatic enrolment into a personal account. There are uncertainties about the number of people who might choose to opt out but we estimate that between 5 and 8 million employees will remain in personal accounts. Women, those working part-time, low and moderate earners are those less likely to have current pension provision and therefore will be well represented in our target group.

Others may choose to opt in to the scheme. The scheme will be available to both the self-employed and those not in paid work. It is difficult to estimate how many individuals in these groups will want to join the scheme but, in the long term, over 1 million of these individuals may opt in to personal accounts.

In total, we estimate that when up and running, the personal accounts scheme might have between 6 and 10 million members.

In addition, we estimate that over half a million people will be newly automatically enrolled into their employer's existing scheme.

The design of personal accounts

1.50 The key objectives in designing a system to deliver personal accounts are that:

- the administrative burden on employers should be minimised;
- accounts should be fully portable for people moving between employers, periods of employment, self-employment and economic inactivity;
- individuals should have the appropriate level of choice to take personal responsibility for saving for their retirement;
- government involvement in delivery should be minimised;
- people should receive high and consistent standards of service; and
- costs and charges should be as low as possible.

1.51 The Pensions Commission recommended the introduction of a new, high-coverage, low-cost National Pension Savings Scheme (NPSS). They suggested that the NPSS should be established as a non-departmental public body with the administration, servicing and fund management functions outsourced to private contractors.

Box 1c: The Pensions Commission's proposal

- Automatic enrolment (with the option to opt out) for all employees into either a high-quality employer scheme or into a new National Pension Savings Scheme (or personal account).
- Minimum total default contributions of 8 per cent on a band of earnings (between the Primary Threshold and the Upper Earnings Limit for National Insurance contributions), with encouragement to save more.
- A low-cost national savings scheme, with a suggested annual management charge of 0.3 per cent in the long run.
- Individuals choose how to invest their funds and a small number of bulk-bought options are available.

1.52 After the publication of the Pensions Commission's second report, the Government invited the pensions industry to consider this proposal and, if appropriate, to suggest alternative ways in which the same broad outcomes of wider coverage and low-cost pension saving could be achieved. The Government is grateful for the effort and engagement shown by the pensions industry to meet the challenges set out by the Pensions Commission.

1.53 All of the alternative proposals we received agreed with the Pensions Commission that automatic enrolment should be the key entry mechanism into the scheme and that a modest minimum employer contribution should be introduced at the levels proposed.

Box 1d: A challenge to the pensions industry

Following the publication of the Pensions Commission's report, the Government challenged the pensions industry to come up with ways to deliver personal accounts.

The **National Association of Pension Funds (NAPF)** proposed a model of Supertrusts, which built on existing multi-employer occupational schemes. There would be between 10 and 20 Supertrusts, which would each be overseen by a board of governors who would outsource operations. Under the scheme, employers would choose which Supertrust their employees joined. Employees would not be able to choose their investment strategy – the board of governors would do that for all members.

The **Association of British Insurers (ABI)** put forward Partnership Pensions as a way of delivering personal accounts. This system built on the existing stakeholder pension platform, where collections were paid directly from employers to pension providers through the BACS system of collection. In addition, they proposed a Retirement Income Commission to oversee the system and ensure that it worked for individuals. Again, they proposed that the initial choice of providers lay with employers but that individuals could make a different choice if they wished.

The **Investment Managers Association (IMA)** put forward an option based largely on the Pensions Commission's proposals, but focusing on how some of the processes, such as governance and fund management, could work in practice.

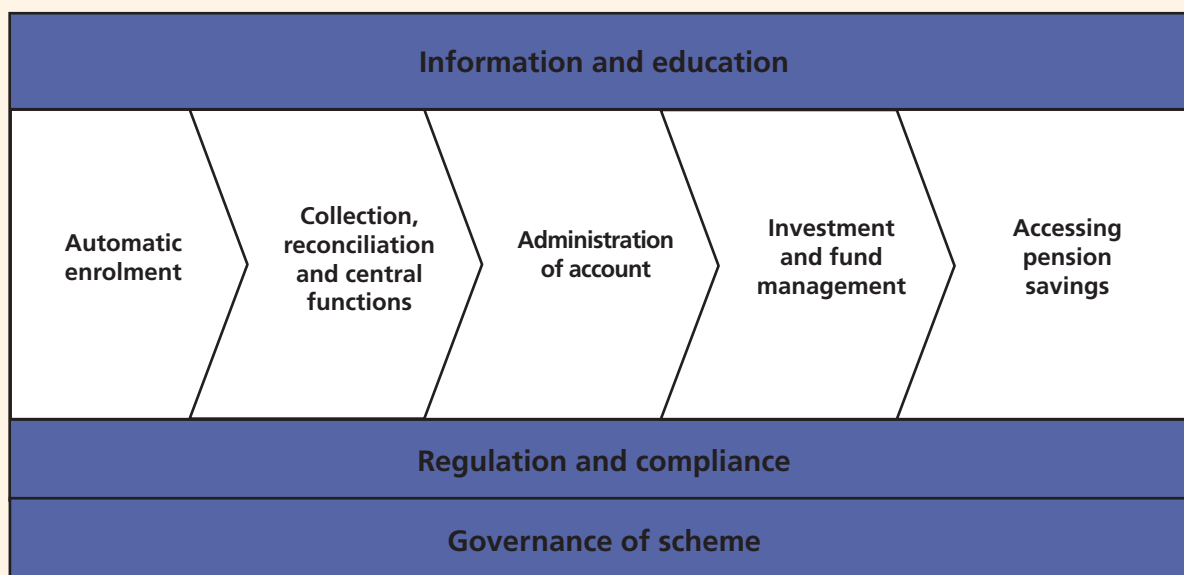
The Government has carefully considered these options and concluded that neither Supertrusts nor Partnership Pensions contain all of the features needed for personal accounts. We believe that a successful system must be designed around personal responsibility and appropriate levels of choice. In addition, the burden on employers must be minimised.

However, we have used features of all of these proposals to refine and improve the models we are outlining in this paper. Moreover, in the next phase of reform, we want to continue to work with the pensions industry to find the best solution to deliver personal accounts. We are also interested in looking at whether Supertrusts could work alongside personal accounts to offer more choice in pension provision.

Delivering personal accounts

1.54 We have analysed carefully the proposals put forward by the Pensions Commission and key stakeholders for delivering a personal accounts scheme. In the light of that analysis and the objectives set out above we have identified the features and functions that will need to exist in any new system.

Figure 1.v An overview of a personal account scheme



Collection and reconciliation

1.55 After individuals have joined the system, they will need to start contributing to their personal account. We propose that there should be a simple, low-cost payment-collection system. This will be delivered in a way that does not place an undue burden on employers. We will be working with employers to ensure that they have confidence in the collection mechanism and that the process of collection is as straightforward as possible.

1.56 In addition to central collection of contributions, we believe that further personal account scheme functions will need to be centralised in order to:

- allocate a default pension provider or pension fund for those individuals who do not make an active choice;
- ensure that individuals can continue to contribute to a single personal account as their circumstances change;

- provide information from a single point to assist the regulator as it monitors scheme compliance; and
- ensure individuals receive a consistent level of service.

Transferring between employers

1.57 One of the key functions of personal accounts is that contributions will continue when individuals move between participating employers. Research¹⁸ suggests that the ability to move the account between employers was thought to be a particularly important feature: people felt that this would increase a sense of ownership of the pension, would encourage those people who change jobs frequently to participate and would overcome the current problem many people face of keeping track of pensions from different jobs. Research with employers similarly revealed that they view this as an important feature. They thought a pension that individuals could take with them as they moved employers would be both popular with employees and encourage them to stay opted-in to a scheme.¹⁹

Compliance

- 1.58 Employees will gain important new rights under the proposals – automatic enrolment into either a personal account or qualifying workplace scheme and access to an employer contribution. It will be important to safeguard those rights by putting in place an effective compliance regime which remains light-touch, risk-based and proportionate.
- 1.59 It is important that employers get the help and support they need to move to the new scheme. We would seek to make it as easy as possible for employers to comply with the new requirements. We will develop a full employer communications and education package to support the introduction and implementation of personal accounts.
- 1.60 However, a range of enforcement powers will also be needed to enable regulatory authorities to respond to the minority of employers who persistently fail to comply with their obligations.
- 1.61 We are giving careful consideration to the precise nature of the regulatory approach, the necessary enforcement powers and how they might be applied.

¹⁸ Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

¹⁹ Research by BMRB for DWP (Marshall H and Thomas A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a qualitative study*).

Administering personal accounts: two distinct approaches

- 1.62 As outlined above, the core elements of a new personal accounts system will be automatic enrolment, a simple mechanism for collecting contributions and some centralised functions. However, there is one remaining issue – the administration of the accounts, on which we would like to consult further. The decision we take on this issue will depend, among other things, on the appropriate role for consumer choice in this area of retail financial services.
- 1.63 Whichever delivery mechanism is favoured, individuals will have a number of choices to make in personal accounts.
- Do I opt out of the scheme?
 - What sort of investments should I make?
 - Should I make additional contributions?
- 1.64 In answering all these questions, people can adjust their decisions to save and invest to meet their own personal needs, their preferences and their aspirations for retirement.
- 1.65 As part of our consultation and discussions with commentators, a number of people have suggested that there is value in offering individuals a further choice:
- Who do I want to **administer** my pension?
- 1.66 Therefore, we are outlining two possible approaches to administering personal accounts.

Option 1: The Pensions Commission's approach – competition for contracts

- 1.67 The Pensions Commission suggested that all personal accounts should be provided by a single organisation. The day-to-day running of the scheme would be outsourced to a number of pension administrators. Everyone would deal with the NPSS and would receive consistent service standards and outcomes. Individuals would be able to make decisions about whether to opt out of the scheme, whether to contribute above the minimum and their preferred approach to investment.

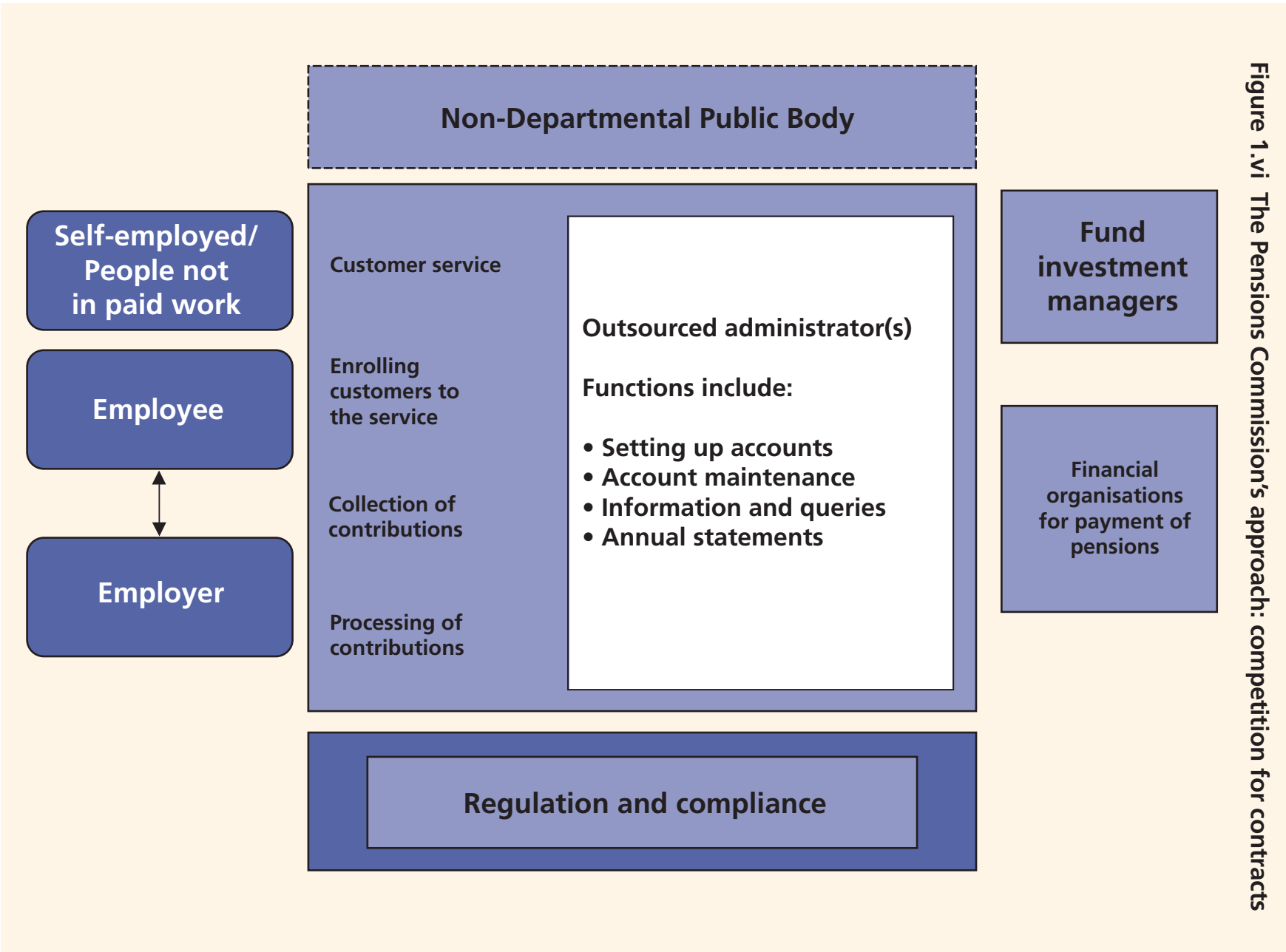


Figure 1.vi The Pensions Commission's approach: competition for contracts

Option 2: An alternative approach – competition through branded providers

- 1.68 Another option to deliver personal accounts would be to build on existing pension provision. Automatic enrolment, collection and compliance would be as outlined in this paper. However, rather than using a single organisation, a number of pension providers would offer personal accounts. This option has a number of differences to the one proposed by the Association of British Insurers (outlined in Box 1d). For example, it would have a centralised function to collect and reconcile contributions, allocate default providers and collate information. People would be able to choose the provider that was right for them (or they would be allocated one).
- 1.69 A model in which individuals have a choice of provider is likely to be more expensive to administer. We would also need to consider whether introducing additional choice for the consumer would add risks that may require regulatory intervention with consequent costs. This could have an impact on the final individual fund size. However, the advantage of this approach is that it would rely to a greater extent on the existing infrastructure and could therefore have advantages when coming to implementation.

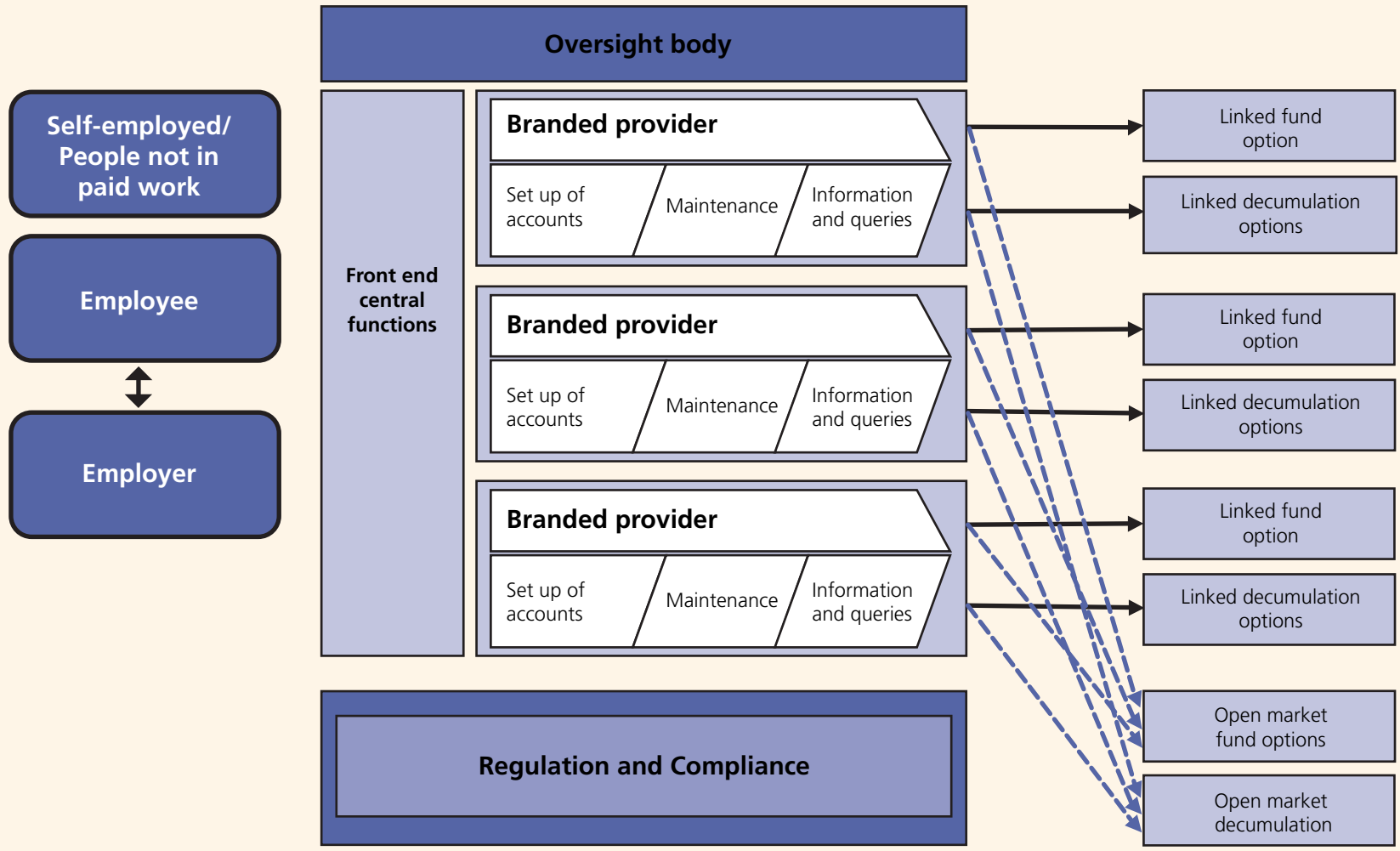


Figure 1. vii An alternative approach: competition through branded providers

1.70 We are interested in views on whether this is a choice that people would benefit from making.

- Would offering a choice of branded provider add value for the consumer?
- Would a choice of branded provider give individuals greater confidence in the system and greater ownership of their accounts?
- What is the connection between type of choice and cost?
- On what basis would individuals make a choice of pension provider?
- What are the pros and cons of vertically integrated providers, offering both administration and fund management?
- With multiple providers how could charges be set in a way that encourages competition to thrive?
- Would it be possible to restrict the number of providers in the scheme to provide scale economies and drive down costs?
- In each approach what information would individuals need?

Box 1e: The importance of individual choice in personal accounts

In the Pension Commission's approach, the NPSS would be responsible for day-to-day administration of all accounts, though consumers would still be able to make a choice between investments. In the alternative approach consumers would face two choices. The first would be between branded pension providers to administer their personal accounts, and the second would be a choice between investments offered by that provider. (In both approaches, in the absence of a consumer choice the individual would be allocated into the default option(s).)

These differences are set out in the figures below. Figure 1.viii shows the choices confronting the consumer in the Pensions Commission's approach, Figure 1.ix the choices confronting the consumer in the alternative approach.

Figure 1.viii Facing fund choice

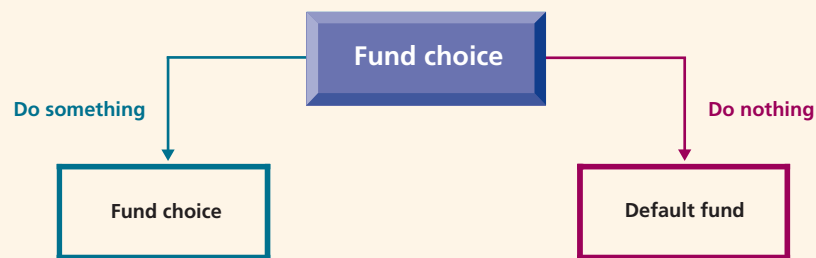
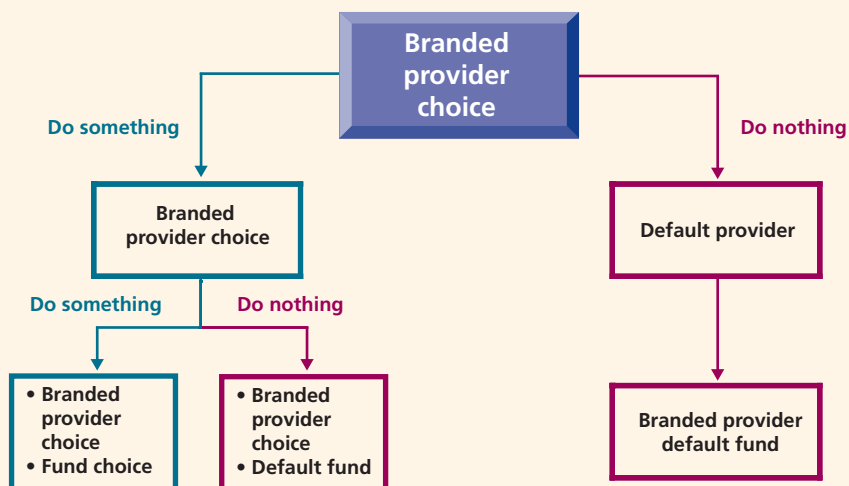


Figure 1.ix Facing brand choice



Box 1e: The importance of individual choice in personal accounts (continued)

If consumers are well informed, choice can help drive competition, innovation and quality. However, evidence indicates that many people do not make well-informed choices or shop around when purchasing financial products. Survey evidence²⁰ indicates that people feel overwhelmed and confused by the amount of information available and the complexity of the choices they face; 20 per cent of people reported that they had made a decision without seeking any advice or information to help them make their decision.

People tend to choose financial products on the basis of familiarity: for example BMRB²¹ found that 58 per cent of products were bought from a company where the respondent was already a customer.

Consumers tend to prefer less choice when purchasing pension products; too much choice leads to inaction and confusion. For example, recent focus groups on personal accounts suggested that having a choice of providers would add a layer of complexity and would not generally be welcomed by people.²² UK qualitative research²³ also suggests that less financially informed respondents wanted a simplified product.

1.71 Initial analysis suggests that the best delivery model is that proposed by the Pensions Commission. However, the Government will conduct further analysis of this and the alternatives in order to strike the best balance between value for money for the taxpayer and value for money for the saver. We wish to consult further on the administration of personal accounts. In assessing approaches, our key objectives will be minimising the cost to members of the scheme and maximising effective competition between firms involved in the provision of the scheme. In conducting this consultation, we will analyse options against the following criteria:

- the level of charges, both in the short and long term;
- value for money for the taxpayer;
- the appropriate type of consumer choice;
- simplicity for employers and individuals;
- the promotion of personal responsibility;

²⁰ Atkinson A, McKay S, Kempson E and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, FSA Consumer Research 47, Financial Services Authority (FSA); www.fsa.gov.uk/pubs/consumer-research/crpr47.pdf

²¹ FSA, 2000, *Better informed consumers: Assessing the implications for consumer education of research by BMRB*.

²² Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

²³ For example ABI, *The pensions annuity market: Consumer perceptions*.

- the administrative burden on employers;
- implementation timetable;
- the level of overall risk;
- the governance of the scheme;
- consumer protection; and
- maximising effective competition between firms.

1.72 We will bring forward proposals on the approach to administration in personal accounts later this year.

Governance of the scheme

- 1.73 Regardless of which approach to delivery is taken forward, a personal accounts scheme requires a robust governance and regulatory regime. Such a regime will need to be transparent, sustainable and create consumer confidence. Personal accounts would be managed independently from government, including decisions on the range of fund choices and the structure of the default fund.
- 1.74 In seeking the right structure to achieve these goals, we will be drawing on expertise from the financial sector, existing regulatory organisations and international experience. Irrespective of who administers personal accounts, our focus will be on ensuring that the governance body will provide an overriding duty of care to scheme members. It will provide them with assurances that their accounts are being administered efficiently and will inform individuals about their investment choices.

Investment and fund management

- 1.75 Personal accounts will build funds on a defined contribution basis. As with all defined contribution products, the value of the individual's fund can fluctuate over time due to changing investment performance. For example, the value of stocks and shares can decrease as well as increase. The risk that investments do not do as well as expected lies with the saver, though this risk can be mitigated by an investment strategy that progressively moves funds into less volatile investments as the individual nears retirement (often referred to as 'lifestyling'). There is no absolute guarantee that the value of the fund would be more than the value of the contributions invested, and that there would be investment growth. The value of these investments therefore cannot be underwritten by government.
- 1.76 Funds will be passed on to professional and independent fund managers for investment, as in current industry practice. We will ensure that a range of investment options, including socially responsible investment, will be provided under personal accounts.

Accessing pension savings

- 1.77 Personal accounts will be subject to the same annuitisation rules as other pension schemes. We expect that most individuals will buy an annuity when they come to take their pension. This reflects the current system, which enables individuals to decide when to annuitise and to shop around for the best product and a price to suit their personal circumstances.

Box 1f: Annuities

The Government considers that annuities are the most appropriate way to secure an income in retirement and this applies equally to personal accounts.

The Government provides tax incentives to encourage people to save for retirement. A 25 per cent tax-free lump sum can be taken from the pension pot but the rest must be converted into a secure retirement income for life by age 75, usually by buying an annuity. This protects people from the risk of running out of money in retirement as people tend to underestimate how long they will live.²⁴ Research shows that pensioners want 'security', 'a guaranteed income level' and 'little or no risk'²⁵, and so it is not surprising that studies show annuities offer good value for money, since this is what they provide.²⁶

The Pensions Commission endorsed the fundamental principle of an income in retirement being secured by an annuity. It suggested consideration of changes to encourage a market for draw-down products,²⁷ compulsory annuitisation being limited in amount and ages of first and last possible annuitisation rising in line with life expectancy.

The Government discussed the economics of mass market draw down with stakeholders and found it was likely to remain viable only for those with large pension pots or sufficient other assets to bear investment risk. However, other new products might be suitable for the mid market and the Government has provided the framework under the current tax and regulatory regime for the market to develop these. The Government is encouraged by the emergence of such 'mid-market' products.

The Government has ruled out allowing an upper limit on the amount individuals have to annuitise. Such a change would only affect a small number of better-off individuals and would add considerable complexity.

²⁴ Women aged 60–69 underestimate their life expectancy by more than four years, and men by more than two years. Source: O'Brien, Fenn and Diacon, 2005.

²⁵ ABI, 2004, *The pensions annuity market: Consumer perceptions*.

²⁶ Discussed in Cannon and Tonks, *Annuities pricing survey*, DWP Research Paper.

²⁷ Draw down exists as an alternative to annuitisation until 75, whereby people can leave their pension fund invested and draw an income by cashing in portions of their fund. Draw down is currently only economic for larger funds.

Box 1f: Annuities *(continued)*

The age of first annuitisation is already increasing from 50 to 55 from 2010. Latest available evidence suggests that 75 is the appropriate upper age limit. The Government is prepared to monitor and review any new evidence as to whether the first and last age limits should be changed in the future.

The Pensions Commission said that the focus of policy should be to encourage later annuitisation. While the age of annuitisation is a decision for individuals, the Government agrees that delaying annuitisation may be beneficial for some, particularly as the current flexibility is only used by a minority²⁸ and evidence suggests the benefits of later annuitisation are poorly understood.²⁹ The Government will work with stakeholders to improve information and will be setting out more technical details on annuities and the underlying evidence base later in the year.

Low charges

- 1.78 The Pensions Commission suggested that there could be an annual management charge of 0.3 per cent in the long run. The Government believes that it is critical that charges for personal accounts are maintained at as low a level as possible. Under a 1.5 per cent management charge, an individual saving for 40 years will lose around 20 per cent of their pension compared with a charge of 0.5 per cent.
- 1.79 In the long term, we are confident that we can deliver a system that radically reduces charges, and which will be self-financing. In the short term, charges will need to reflect the choice of delivery mechanism, funds under management, contract specification and financing arrangements. We will also consider other funding structures for personal accounts.

²⁸ Only 5 per cent choose to annuitise between ages 70 and 74. Source: *The future of the pension annuity market*, 2003.

²⁹ ABI sources already cited.

Box 1g: Why are low charges important?

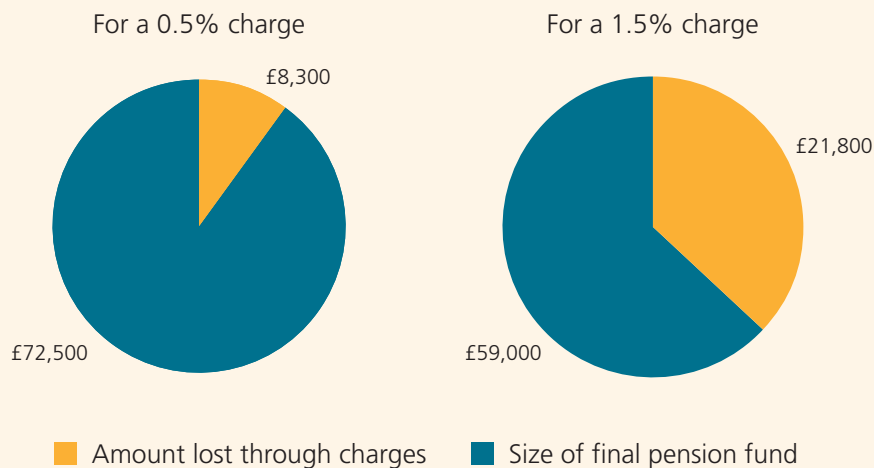
A higher annual management charge (AMC)³⁰ means that, for a given rate of pension contribution and fund growth, less money is accumulated in an individual's pension fund each year. Consequently, less growth is accrued and compounded each year, ultimately resulting in a smaller pension fund and, all else being equal, a smaller pension income upon retirement. Furthermore, this effect is more significant the longer the duration of saving. This is because deductions are made from a pension fund that is accumulated over the years, which affects the return earned from fund growth each year, thereby affecting the size of the final fund.

Figure 1.x illustrates this for a median earner (£23,000) who saves in a pension for 40 years.³¹ Under a 0.5 per cent charge, their pension fund at retirement is worth £73,000, meaning that £8,000 of their fund has been lost in charges; whereas under a 1.5 per cent charge, their pension fund is worth £59,000 and £22,000 is lost in charges.³² This individual's pension fund is therefore approximately 20 per cent smaller purely as a result of the difference in charges. This pattern of variation across charges is similar for all earnings levels, although the absolute size of pension funds varies proportionately according to different income levels.

³⁰ An annual management charge is a charge made each year by managers of a pension fund to each pension account holder, to cover the expenses associated with running the individual's fund. Although it is conventionally expressed as a percentage of funds under management, it is usually deducted from individual accounts monthly. Other charging structures can be used, for example charges on contributions or on early termination of contracts. Not all of these structures are permissible on all products, for example stakeholder pensions cannot impose an exit charge.

³¹ In this analysis we assume that there is no relationship between annual management charges and the returns achieved by managers for investors. 'Active' fund managers usually charge much higher fees compared with 'passive' fund managers, but evidence to date suggests that both types of fund managers achieve a similar rate of return. Research on this area is ongoing.

³² The amount lost in charges was calculated as the difference between the fund size under the relevant charge compared to what the size of the fund would be under a zero charge.

Box 1g: Why are low charges important? (continued)**Figure 1.x How higher charges reduce the pension fund size of a median earner (£23,000) who saves for 40 years**

Source: DWP modelling

Notes: The amount lost through charges was calculated as the difference between the pension fund size under the relevant charge compared with what the fund size would be under a zero charge.

Assumes total contribution rate of 8%, and pension fund growth of 6.5% per year. Figures have been rounded to the nearest £100.

Is 0.3 per cent achievable?

- 1.80 Much of the debate since the publication of the Pensions Commission report has focused on whether a system of personal accounts could be delivered at such low costs.
- 1.81 The current system of private saving has a number of costs that can be reduced or eradicated in the system we are proposing. The use of automatic enrolment should drive down the costs of marketing and acquisition. The establishment of a central body would increase portability, reducing the number of times high start-up costs for accounts would be incurred. And the establishment of a central body would ensure that persistency of saving is increased, further reducing the costs of saving through fewer, but larger, pension funds.
- 1.82 The exact cost of the scheme will be dependent on the final design, the financing of the scheme and the service it offers to consumers. We believe that 0.3 per cent may be achievable in the long term, depending on decisions we take on scheme design. We invite views on this and will put forward proposals later this year.

Automatic enrolment for employees

The case for automatic enrolment

- 1.83 Automatic enrolment introduces a presumption to save but does not mean that employees will be compelled to save – they will be able to opt out of the scheme if they wish. But unlike the present situation in most pension schemes, where an active decision must be taken to join, with automatic enrolment people need to take an active decision to opt out. People who want to save but do not get around to making the decision to start will no longer lose out.
- 1.84 The principle that automatic enrolment should form a key part of the new national pensions saving scheme has generated widespread support and consensus from stakeholders and interest groups.³³ Since the publication of the Pensions Commission's second report, there have been expressions of support for the proposal from representatives of employees, consumers and employers. Preliminary findings from our survey of employers³⁴ indicate that the majority of employers agree that automatically enrolling employees into a pension scheme is a good idea.

³³ Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

³⁴ Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

Box 1h: Automatic enrolment: the evidence

Evidence suggests that automatic enrolment is one of the most effective ways of combating people's tendency not to act when faced with difficult financial decisions. It will play a key role in achieving high participation rates for personal accounts.

The *Employers' Pension Provision Survey 2005* findings show a link between automatic enrolment and increased levels of pension scheme membership. Within private firms with 20 or more employees, the proportion of employees that were in a pension averaged 60 per cent (median 77 per cent) where the firm used **automatic enrolment**. This compared with 41 per cent for **traditional opt-in**.

In case studies of four private sector schemes, automatic enrolment was associated with increased participation rates.³⁵ For example, in one firm the participation rate went from 25 per cent for existing employees, to 80 per cent for new joiners who were automatically enrolled.

Automatic enrolment has the greatest impact among groups where participation rates are low. American research into 401(k) schemes showed that automatic enrolment had the largest effect among people with low incomes, minority ethnic groups and women.³⁶ Given the low pension provision among these groups, we would expect their participation rates to increase most from the introduction of automatic enrolment.

Research with employers showed that a majority of them (60 per cent) were in favour of automatic enrolment. This support was across firms of all sizes. Among those with less than five employees, 60 per cent of employers were in favour, and 72 per cent of employers with more than 50 employees were in favour.³⁷

There is equally strong support among individuals. At the National Pensions Day, 92 per cent of people were in favour of automatic enrolment.³⁸

"It saves you the hassle of trying to sort out pensions really."

"People who are out there thinking, 'Oh, I'll get round to it' – it's there, it's done for them."

Participants in research for DWP on attitudes to personal accounts.³⁹

³⁵ Horack and Wood, 2005, *An evaluation of scheme joining techniques in workplace pension schemes with an employer contribution*, DWP Research Report 292. Note: other factors including a required employee contribution, supporting communications and employer commitment may have influenced the outcomes achieved.

³⁶ Madrian and Shea, 2002, in Munnell and Sunden, 2004, *Coming up short: The challenge of 401(k) plans*, The Brookings Institute.

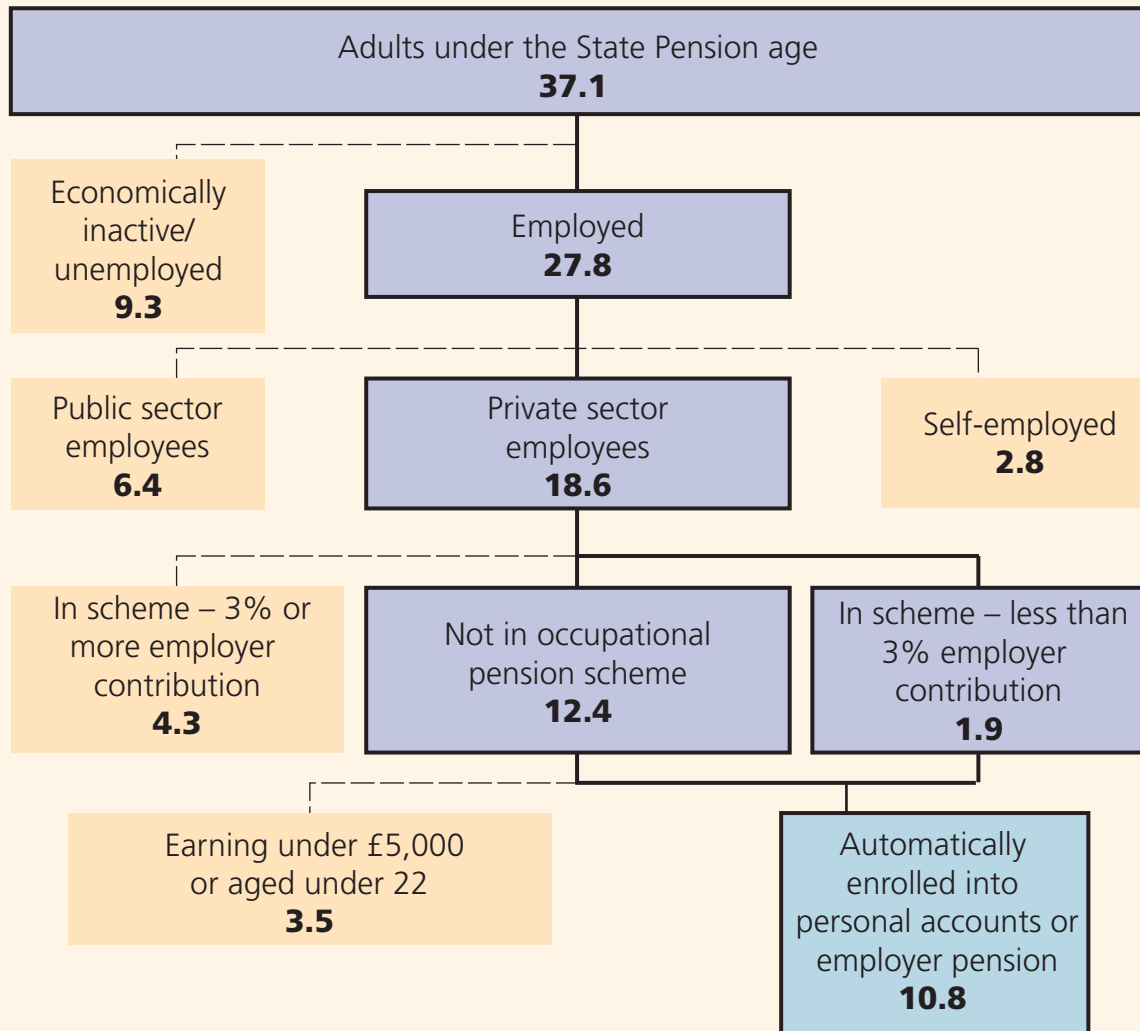
³⁷ Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a quantitative survey*.

³⁸ Opinion Leader Research, 2006, *National Pensions Debate Final Report* prepared for DWP.

³⁹ Hall S, Pettigrew N and Harvey P, forthcoming in 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*.

Who should be automatically enrolled?

- 1.85 All eligible employees will be automatically enrolled into a pension scheme, either the new national scheme of personal accounts or an employer scheme offering equivalent or greater benefits.
- 1.86 We have looked closely at the age and income level at which automatic enrolment should begin, from the point of view of both employees and employers. We have concluded that employees should be automatically enrolled when their earnings are above a lower threshold of around £5,000 a year. This is also when contributions would begin to be paid (contribution band levels are explained in paragraph 1.103).
- 1.87 This is a suitable point to automatically enrol employees because we want to bring as many employees into the scheme as possible, at a level of contributions they are likely to be able to afford. Because contributions will be calculated on a band of earnings starting at around £5,000 a year, costs will be low for people earning just above this level. Low earners will be brought into pension saving, will get into the savings habit, will see their savings increase as their earnings grow and, of course, they will have the right to opt out.
- 1.88 The Pensions Commission recommended that employees should be automatically enrolled from the age of 21. We have looked closely at this issue. Our judgement is that, to maximise the simplicity of the scheme and minimise administrative burdens on employers, there is a case for aligning the age at which people are automatically enrolled at 22 – the age at which the adult rate for the National Minimum Wage is payable.
- 1.89 We intend that:
- employees aged 22 or over will be automatically enrolled into a personal account when commencing employment, or into alternative workplace provision, if it is available to them;
 - employees will be automatically enrolled on changing employer, and then every three years, should they initially choose to opt out and continue to work for the same employer; and
 - employees will be automatically enrolled when their earnings reach the lower threshold.
- 1.90 We estimate that starting automatic enrolment at this age and level of earnings will mean that around 10 million employees will be eligible for enrolment into the scheme, including many part-time workers (as shown in Figure 1.xi).

Figure 1.xi Eligibility for automatic enrolment, millions

Source: DWP modelling based on Family Resources Survey 2004/05, Employers' Pension Provision Survey 2005, and Annual Survey of Hours and Earnings 2004 and Small and Medium-sized Enterprise Statistics 2004

Note: Figures may not sum due to rounding.

Opt-in access to personal accounts

1.91 Automatic enrolment will not apply to people who are:

- self-employed;
- not in paid work;
- over State Pension age; or
- under 22 years of age.

- 1.92 As we want to encourage all individuals to save for their retirement, these groups will be able to join personal accounts on an opt-in basis, with individuals taking an active decision to participate.
- 1.93 The self-employed and those not in paid work, by definition, have no access to an employer contribution and so may need to think carefully about pension saving decisions. We think it is important that they should have access to low-cost personal accounts if they wish to save.

People who are self-employed

- 1.94 The self-employed make up a key segment of our target group. Box 1i looks in more detail at the self-employed and pension-saving behaviour.

Box 1i: Pension saving and the self-employed

There are currently approximately 3 million working-age self-employed people in the UK.⁴⁰ There has been a steady long-term decline in the proportion of self-employed people who are contributing to private pensions. This is illustrated in the *General Household Survey*, which shows that 66 per cent of full-time self-employed males belonged to a personal pension in 1991/92 but this had declined to 49 per cent by 2003/04.

As a group and across the income distribution, self-employed people aged 50 to State Pension age have, on average, lower state and private pension wealth but higher non-pension wealth than the employed.⁴¹ In terms of total wealth (given by the sum of State Pension, private pension and non-pension wealth), the self-employed as a group have much higher total wealth than the employed.

- 1.95 We recognise that participation rates for personal accounts could be affected if the self-employed are not able to join the scheme easily. After detailed consideration, we have concluded that there is no practical way of providing an automatic enrolment process for this group. This is because it would not be possible to deduct personal account contributions from income, or to presume a minimum contribution rate. Therefore, we propose to offer membership on an opt-in basis. To encourage participation levels, access to the scheme will be straightforward and simple, helping to minimise the effort required to join and contribute. And the tax benefits of pension savings will be clearly signalled.

⁴⁰ All figures are derived from the *Family Resources Survey* (FRS) 2005 unless otherwise stated.

⁴¹ Non-pension wealth, broadly speaking, consists of owner-occupied housing and non-housing wealth. Non-housing wealth consists of financial wealth (like savings and shares) and physical wealth like a business or investment property.

People who are not in paid work

- 1.96 Those people who are not active in the labour market, including those with caring responsibilities, may want to start or continue to save in personal accounts during these breaks from the labour market. We propose that people who are not in paid work should be able to contribute to personal accounts.
- 1.97 Tax relief on pensions is payable to people outside of the labour market. Receiving £28 from the Government for every £100 they contribute, up to a maximum of £3,600 of total contributions a year, could provide an incentive for the individuals in this group to join the personal accounts scheme.

People over State Pension age and young employees

- 1.98 It is appropriate that those who want to continue to work and save after State Pension age can make a conscious decision to do so. People over State Pension age who are in employment will not be automatically enrolled but will be entitled to opt in to personal accounts and receive an employer contribution. People still in employment with a personal account when they reach State Pension age will remain within it unless they choose to opt out. People over 74 will not be able to remain in the scheme, since in line with other defined contribution schemes, funds held in the scheme must secure an income by the age of 75. Young people aged between 16 and 21 will be able to save in a personal account on an opt-in basis and have access to an employer contribution.

Contribution levels

- 1.99 Everyone will have their own view of the level of income they want to have in retirement. Therefore personal accounts need to be as flexible as possible. The Pensions Commission suggested a minimum total contribution of 8 per cent on a band of earnings. Our analysis and research suggests that this is the right level.
- 1.100 The Pensions Commission research⁴² suggested that most median earners expect replacement rates in the range 45–67 per cent and, crucially, very few want less than 45 per cent. Contributions of 8 per cent, combined with a State Pension as outlined in Chapter 3, should be enough on average to deliver replacement rates of around 45 per cent for lifetime median earners who start saving at around age 30, and more for those starting to save at a younger age.

⁴² Pensions Commission, 2005, *A new pension settlement for the twenty-first century: The second report of the Pensions Commission*, Appendix D.

- 1.101 We propose to set minimum contribution levels at 8 per cent to help individuals align with the lower end of the replacement rate range identified in the research. We recognise that people have different expectations of retirement income, and may have other savings and assets that can add to their retirement income. The aim of our policy is to provide people with a simple, low-cost way of pension saving which results in a reasonable level of retirement income and provides the flexibility for additional savings.
- 1.102 We have set the rate of contributions for the new scheme of personal accounts in such a way that it could achieve a replacement rate of around 45 per cent of earnings for a median earner with a reasonably full working life. Actual replacement rates can vary substantially depending on earnings, employment status, the age at which saving starts, National Insurance record, investment choices and returns, and annuity choices. These replacement rates should therefore be seen as a guide for setting contribution rates rather than implying certainty about replacement rate outcomes.

The band of earnings on which contributions are paid

- 1.103 The Pensions Commission proposed that the earnings band should start at the Primary Threshold for National Insurance purposes (currently £5,035) and finish at the Upper Earnings Limit (currently £33,540).
- 1.104 By calculating contributions on a band of earnings from around £5,000 to around £33,000 rather than all earnings:
- the cost of contributions will be lower for the lowest earners and their employers, and costs will be limited for those employing higher earners;
 - it will avoid the 'cliff edge' that would arise at the point of automatic enrolment if contributions were based on all earnings; and
 - contributions will begin at around the same point as tax and National Insurance contributions, the earnings level at which individuals begin to take responsibility for retirement saving by contributing to their State Pension.
- 1.105 We have looked at this issue carefully and agree with the Pensions Commission that the minimum contribution levels proposed are the right ones and that the band proposed is broadly right. In research, the majority of employers thought that the proposed levels of employer and employee contributions were about right and there was support for the idea that these should be based on banded earnings.⁴³

⁴³ Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a quantitative survey*. And Marshal H and Thomas A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a qualitative study*.

In other research individuals agreed that the contribution levels were about right.⁴⁴ The Commission recommended that the value of contributions in relation to earnings over time should be maintained, and we are exploring ways to achieve this.

The balance of responsibilities between individuals, employers and the State

1.106 The Pensions Commission suggested that the 8 per cent contribution should comprise:

- employers contributing 3 per cent;
- employees contributing 4 per cent; and
- the State contributing 1 per cent as normal tax relief, as under the current rules.⁴⁵

1.107 Our research showed that people think the recommendations set out by the Pensions Commission offer a fair balance of responsibilities between individuals, their employers and the State.⁴⁶

The case for a national minimum employer contribution

1.108 The Pensions Commission made a strong case for the need for an employer contribution to pensions. We propose that employees will have access to contributions from their employer on a band of earnings if they are saving in a qualifying workplace scheme or a personal account. This will give a new group of employees a real incentive to save and will mean that millions of people, for the first time, will have access to a minimum employer contribution to supplement their own savings.

1.109 This is not a decision that has been taken lightly but we have been convinced that an employer contribution has two main advantages:

- It increases participation rates – driving down costs and helping more individuals to build up pension savings.
- It makes savings more attractive – increasing the incentives to save and making saving decisions more straightforward.

⁴⁴ Hall S, Pettigrew N and Harvey P, forthcoming in 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*.

⁴⁵ 1 per cent represents basic rate tax relief on individuals' contributions – in addition, individuals may be entitled to higher-rate tax relief and neither employers nor employees pay tax or National Insurance contributions on employer contributions.

⁴⁶ Hall S, Pettigrew N and Harvey P, forthcoming in 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*.

Increasing participation rates

- 1.110 The Pensions Commission noted in its final report that the employer contribution is an essential element of the personal accounts package, and that without it, participation rates would be significantly lower.
- 1.111 There is a growing body of evidence which clearly demonstrates that there is an association between an employer contribution and increased participation rates, and that an employer contribution helps people to save. The key to a successful personal accounts system will be high levels of participation. It is only by making it an attractive system to a large part of our target group that we can drive down costs significantly.

Box 1j: Evidence for a minimum employer contribution: increase in scheme membership

- The *Employers' Pension Provision Survey 2005* suggests a positive relationship between an employer's pension contributions and levels of scheme membership. In firms with at least one scheme member, where there was no employer contribution, 28 per cent of employees were members; with a contribution of less than 3 per cent, 47 per cent of employees were members; with a contribution of more than 3 per cent but less than 6 per cent, 53 per cent of employees joined; and with an employer contribution of 6 per cent or more, membership levels rose to 60 per cent.⁴⁷
- The Employer Task Force reported that 72 per cent of employees with access to an employer's pension scheme with an employer contribution are saving in a pension. Only 21 per cent of those who do not have access to an employer contribution are saving privately.⁴⁸
- Preliminary findings from our research with employers indicate that the majority of employers were in favour of a minimum level of employer contribution. Larger employers tend to be more likely to be in favour than smaller ones (just over seven in ten of those with 250 or more employees are in favour compared with just over half of those with less than 50 employees).⁴⁹

Making saving more attractive

- 1.112 Employer contributions offer a simple and transparent incentive to start saving in a pension. Employees only receive the contribution if they are in the scheme, providing a clear benefit from pension saving. Evidence clearly shows that the idea of an employer contribution is attractive to employees.

⁴⁷ This finding was supported by regression analysis which controls for the effects of other factors. These findings are indicative only, because of missing data on contribution and membership levels and because comparisons were based on very few employers in the survey (12) who made zero contributions.

⁴⁸ Employer Task Force on Pensions, 2004, *Report to SoS for DWP*.

⁴⁹ Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a quantitative survey*.

Box 1k: Evidence for a minimum employer contribution: employee and employer views

- At National Pensions Day, 85 per cent of people thought that employers should make a contribution.
- Quantitative research to gauge people's first reactions to the Pensions Commission report found a majority (70 per cent) of those surveyed believed that all employers should be made to contribute to a pension for their employees. Among employees in the survey who were not members of an employer's pension scheme, 62 per cent said they would begin to contribute to a company pension if their employer did.⁵⁰
- DWP focus group research in November 2005 explored public reactions to pension reform options. In line with other research, the main reason given for joining an employer's scheme was an employer contribution.⁵¹
- Qualitative research exploring initial reactions to personal accounts found that the concept of additional contributions (from employers and the Government) was seen by most as a strong incentive to participate.⁵²
- Research with employers found that a majority of employers were in support of a minimum employer contribution. The reasons given for this support included that they felt they had a share of the responsibility for the issue and that they wanted to help their employees. Furthermore, 66 per cent of micro employers (those with fewer than five employees) felt that a level of 3 per cent was about right or too little. This support rose to 74 per cent among employers with 50 or more employees.⁵³

Impact on other schemes

1.113 Personal accounts are intended to complement, and not replace, existing pension provision from employers. If an employer already offers a suitable alternative scheme, they will be able to seek exemption from the personal accounts scheme and automatically enrol their employees into their existing scheme instead.

⁵⁰ Marketing Sciences Ltd internet and telephone research with over 1,000 people, *Views on the Turner Report*, 2005. The sample for this survey was not nationally representative as it included disproportionate numbers of people whose employers contribute to their pension.

⁵¹ IFF research, forthcoming, *Pensions and savings: 12 focus groups with people aged 18–65*.

⁵² Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

⁵³ Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

- 1.114 We will consult with employers and the pensions industry to develop detailed proposals on the scheme features that would enable an employer to seek exemption. It is important to ensure that such schemes are at least as favourable to employees as personal accounts. For example, we would want to ensure that:
- for defined contribution schemes, the contribution levels into the scheme are at least equal to the minimum contribution levels for personal accounts;
 - for defined benefit schemes, the total benefits accrued by members are at least equal to those that are estimated to accrue from minimum contributions into personal accounts; and
 - automatic enrolment procedures are in place to allow employees in employer schemes the same opportunity to overcome inertia and save that personal accounts will offer.
- 1.115 We will also need to take account of other factors such as the level of charges and waiting periods. We are planning to consult on detailed proposals for how this would work later in the year.
- 1.116 Personal accounts will provide a foundation for private pension saving which will complement existing occupational and private schemes. Some stakeholders have expressed the concern that firms may 'level down' their existing provision to the minimum requirements of the personal account scheme – in particular by reducing their employer contribution level to 3 per cent.
- 1.117 Employers offering pensions with contributions above 3 per cent already have a high proportion of their employees in these schemes. The average contribution for firms contributing above 3 per cent is currently 8.8 per cent. If employers were to level down to cover the cost of paying a 3 per cent contribution for those employees newly enrolled into a pension, average contributions to existing scheme members would have to fall from 8.8 per cent to 8.2 per cent.
- 1.118 Evidence indicates that the extent of levelling down is likely to be limited. Our research indicates that employers who contribute more than 3 per cent view their pension scheme as an important recruitment and retention tool which they want to keep.⁵⁴ Preliminary findings from a quantitative survey indicate that, of those employers contributing 3 per cent or more and who report that the introduction of personal accounts would mean an increase in total pension contributions, only just over 1 per cent said they would level down, and the vast majority of these reported they would level down to a level above 3 per cent. Only 2 per cent of all employers, where the introduction of personal accounts would mean an increase in total pension contributions, reported that they might close their scheme.⁵⁵

⁵⁴ Research by BMRB for DWP (Marshall H and Thomas A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a qualitative study*).

⁵⁵ Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

The impact of a national minimum contribution on employers

1.119 In 2004, £36 billion was contributed to funded pension schemes⁵⁶ by employers.

Based on a rate of participation of around two-thirds in personal accounts, we estimate that additional employer contributions would be worth around £2.6 billion. The exact amount will depend on factors such as employee opt-out rates and earnings levels.

1.120 Firms will face an average increase in their labour costs of 0.6 per cent. This increase is lower than the 3 per cent minimum employer contribution because:

- the 3 per cent contribution is on a band of earnings only and an employee will never get more than 2.5 per cent of their full earnings;
- many employees are already receiving 3 per cent or more, so there is no additional cost for this group;
- not all employees newly eligible for the contribution will take it up; and
- neither employers nor employees pay tax or National Insurance contributions on the employer contribution.

1.121 Figure 1.xii shows the likely amount that an employer will have to pay for a full-time employee. For example, for an employee earning around £23,000 a year, the effect of the requirement to contribute would be equivalent to adding 26p to the hourly wage.⁵⁷

Figure 1.xii Likely employer contributions

Annual earnings (£)	Employer contribution in a year (£)	As a percentage of all earnings (%)	Increase in hourly wage (£)
10,504	164	1.6	0.08
23,000	539	2.3	0.26
30,000	749	2.5	0.36
35,000	855	2.4	0.41

Source: DWP

Notes: Annual earnings of £10,504 is equivalent to being paid at the National Minimum Wage of £5.05 per hour for 40 hours per week, 52 weeks a year including paid holidays.

Annual earnings of £23,000 is the median annual earnings of all people in full-time employment (ASHE 2004).

Results for the increase in the hourly wage are based on someone working 40 hours per week, 52 weeks a year including paid holidays.

Contributions are estimated using the 2006/07 Primary Threshold of £5,035 and the 2006/07 Upper Earnings Limit of £33,540.

⁵⁶ ONS, *Pension trends 2005*.

⁵⁷ If the employee worked 40 hours 52 weeks a year, including paid holidays.

1.122 There are around 1.2 million employers in the private sector.⁵⁸ A minimum employer contribution of 3 per cent on a band of earnings coupled with automatic enrolment of employees would affect three types of employers – those that currently:

- offer no provision or who provide access to a pension but do not contribute (around 980,000 employers);
- offer some pension contributions but less than 3 per cent (around 8,000 employers); and
- offer a contribution of 3 per cent or more (around 170,000 employers), who would face higher participation rates due to automatic enrolment.

1.123 Figure 1.xiii illustrates different types of employer provision broken down by firm size (number of employees). It shows that the majority of firms have fewer than 50 employees, and that these firms are less likely to offer any pension provision.

Figure 1.xiii Employers currently offering a contribution to a pension scheme by firm size

Number of employees in the firm	Number of employers currently offering . . .			Total
	No provision and/or no contributions	Some contributions but less than 3%	Contributions of 3% or more	
1–4	650,000	7,000	110,000	770,000
5–49	310,000	0	53,000	370,000
50–249	19,000	870	5,500	26,000
250+	4,100	34	1,800	6,000
Total	980,000	7,900	170,000	1,200,000

Source: *Employers Pension Provision Survey 2005 and Small and Medium-sized Enterprise Statistics 2004*

Notes: Figures may not add to total due to rounding.
Figures rounded to 2 significant figures.

⁵⁸ Source: Small Business Service.

1.124 Figure 1.xiv illustrates the effects of personal accounts by firm size. It shows that proportionately more employees will be eligible for automatic enrolment in firms with fewer than 50 employees. The minimum contribution as a percentage of labour costs is also higher for these firms.

Figure 1.xiv The effects of personal accounts by firm size				
Firm size (number of employees)	1–4	5–49	50–249	250+
Number of private sector employees (million)	2.2	4.6	2.6	9.1
Number of employees eligible for automatic enrolment (million)	1.4	3.3	1.7	4.4
Personal account participation rates (%)	70	70	65	60
Number of personal account members (million)	0.9	2.2	1.0	2.6
Capped average earnings per participant (£)	15,500	18,300	19,300	18,300
Average cost per employee (£)	140	190	170	110
Costs of minimum employer contribution (£ million)	300	900	400	1,000
Minimum employer contribution as percentage of labour costs (%)	0.9	0.9	0.7	0.5

Sources: DWP modelling using Employers' Pension Provision Survey 2005, Family Resources Survey 2004/05, Annual Survey of Hours and Earnings 2004 and Small- and Medium-sized Enterprise Statistics 2004

Notes: Figures may not sum due to rounding.

Participation rates and costs are based on our central estimate of opt-out at around one third. We estimate that the range of opt-out rates will be between 20% and 50%.

Number of employees who are eligible includes some who we expect may be automatically enrolled into their employer's scheme rather than a personal account. We estimate that around 10 million employees will be automatically enrolled into a personal account. The costs of the minimum employer contribution include the cost of those newly participating in their employers' schemes.

Employers are only mandated to make contributions on earnings between the Primary Threshold and Upper Earnings Limit, and therefore earnings have been capped at £33,540 and actual contributions will be made on earnings above £5,035.

1.125 We will design personal accounts to minimise the burden on employers. Employers will need to undertake a range of tasks which will vary depending on existing payroll systems and the type, and level, of pension provision already offered. There will be some set-up costs and some ongoing tasks. Precise costs will be subject to further detailed design work. At this stage early estimates suggest total set-up costs to all employers could be around £230 million, and total ongoing annual costs around £90 million – about £10 per new scheme member.

Long-term impact

- 1.126 Employers may manage this additional cost in a number of ways. They can adjust prices, offer lower wage increases or absorb the cost through lower profits.⁵⁹ Our research with employers suggests that the majority will use these mechanisms.⁶⁰
- 1.127 Economic theory suggests that the main mechanism for employers will be to pass on the costs through lower wage increases. In the case of personal accounts, a flexible wage response will be facilitated by the fact that participation is voluntary and that individuals will have full ownership over their pension fund.

Employees on the National Minimum Wage

- 1.128 For employers with staff on the National Minimum Wage, the scope for adjustment through lower wage rises will be limited. However, of those who would be automatically enrolled, we estimate only 2 per cent are on the National Minimum Wage. The Low Pay Commission takes into account relevant costs faced by employers when making recommendations about the appropriate level of the National Minimum Wage. Therefore, in the future, they will consider any impact of a national minimum employer contribution.

Support for employers

- 1.129 We have developed a package of measures to help employers manage the transitional impacts of minimum contributions. The key elements of our proposals are that:
- the level of the national minimum employer contribution will be set out in primary legislation, so that employers can have confidence in the stability of this level over time;
 - the minimum employer contribution will be phased in over three years (as will the employee contribution); and
 - employers will be given due notice of the rate and timing of the introduction of the scheme.
- 1.130 The priority is to design the scheme and the transition phase so that burdens on employers are minimised. We will consult on transitional support for the smallest businesses, and on whether a longer phasing period is needed.

⁵⁹ Research by BMRB for DWP (Marshal H and Thomas A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a qualitative study*).

⁶⁰ Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

Choosing to contribute more into a personal account

- 1.131 The minimum levels of contribution set out above are intended to promote a minimum level of saving. Some employers and employees will wish to supplement this by making additional contributions, and we see this as a key component of personal accounts. By supplying scheme members with information and education as their savings grow, the scheme will enable people to take a view on whether they should be saving more.
- 1.132 However, we know that, even with good-quality information, all too often member contributions tend to remain at the minimum contribution level. People have good intentions to increase their pension contributions but never get round to it. One possible way to encourage people to consider increasing the amounts they are contributing to their pension is set out in Box 11.

Box 11: Encouraging people to contribute more to their pension

The Save More Tomorrow (SMarT™) scheme, pioneered in the US using behavioural economics concepts, has successfully increased savings rates in US employer-based retirement programmes. US research studies encouraged employees who were already saving for their pension through the workplace to save more by pre-committing to increase their contributions with each pay rise. Employees were given the choice to leave the plan at any time, but the majority of people who joined stayed in. Findings included:

- 78 per cent of employees who were offered SMarT™ in the first case study joined.
- Of these, approximately 80 per cent remained in the scheme for four saving increments.
- Savings contributions increased until employees reached the maximum allowed contribution (typically within four years).

By giving employees the choice to automatically increase their saving rate by 3 per cent at each future pay rise, the average savings rates, in one US research study, increased from 3.5 per cent to 13.6 per cent in just over three years.⁶¹

⁶¹ Benatzi S and Thaler R, 2003, 'Save more tomorrow: Using behavioural economics to increase employee saving'. *Journal of Political Economy*.

Box 1: Encouraging people to contribute more to their pension *(continued)*

The encouraging results in the US have prompted the Department for Work and Pensions to work with pension providers to facilitate two case studies with employers who contribute to pensions in their workplace to evaluate the effectiveness of this technique in the UK. PIP (Pension Increase Pledge) is the working title of this initiative. The study will examine if employees who are already enrolled in a workplace pension can be encouraged to save more by agreeing to have their contributions automatically increased annually.

The results of this research⁶² will provide us with an insight into ways in which we can increase pension savings in the workplace. This technique may be one way of encouraging people to contribute more and, if effective, we will consider how it can be promoted more widely.

Information and choice

- 1.133 We endorse the Pensions Commission's view that it is vital that communication with members of the new scheme is designed to enable them, as best as possible, to make informed decisions about their saving.⁶³
- 1.134 In the period before implementation, we will be pursuing three distinct strands of work to meet this objective: developing the information and communications strategy to support the introduction of personal accounts; continuing our work on improving public understanding of pensions; and working with the FSA and others on the broader financial capability strategy.
- 1.135 While the exact nature of the communications and information package to support personal accounts will depend on the final model for delivery, the introduction of a new national personal accounts scheme will require both a high-level awareness-raising campaign and the provision of specific information and support to employers, individuals and the voluntary sector.

⁶² Independent researchers have been commissioned to undertake the evaluation and it is hoped to publish initial findings towards the end of 2006.

⁶³ Pensions Commission, 2005, *New pension settlement for the twenty-first century: The second report of the Pensions Commission*.

1.136 Individual members are likely to need more specific information to help them make decisions at key trigger points, including:

- joining – whether this scheme is right for their current circumstances, and the impact of opting out;
- choice of investment – the balance of risk and return and the possible impact of choosing a particular method of funding or a particular investment portfolio;
- continuing membership – assessing the growth of the pension fund and whether to increase the contribution;
- retirement – the impact of different decisions regarding annuitisation before drawing a pension; and
- choice of branded provider – which provider to choose to administer their pension (dependent on scheme design).

1.137 In developing the information and communications strategy for personal accounts, and our work to improve general public understanding of pensions, we will look for lessons we can learn from other countries. In Sweden, for instance, annual state pension forecasts are issued in a clearly branded, coloured envelope since introducing pension reforms. Research conducted in 2005 showed very encouraging results for this with recall levels of 90 per cent, 52 per cent reading the forecast, 18 per cent comparing it with the previous year's statement and 68 per cent describing it as trustworthy.⁶⁴

1.138 New Zealand provides another example. The Retirement Commission is an independent agency whose mission is to assist current and future generations to have an adequate amount of income in retirement through education, information and promotion. Since 1996, they have been running a programme designed to ensure that people in New Zealand understand retirement income policies and, in particular, are aware of the benefits of supplementing their superannuation (the state pension) with private savings.

⁶⁴ Presentation by Arne Paulsson, Informed Choice UK EU Presidency Event 9/11/05.

1.139 We have been working to improve public understanding of pensions through the Informed Choice programme since 2002. We will build on the achievements of this programme alongside our work on personal accounts. We will:

- continue to issue pension forecasts while exploring ways to improve their impact and effect on savings behaviour;
- look at the best way to provide people on low to medium incomes with web-based retirement planning services to give them the information, education and support they need in the context of today's pension system and during the transition to any changes; and
- consider how to increase public awareness of the pension tracing service, the free service we offer to help people trace unclaimed or 'lost' occupational and personal pensions.

Next steps

- 1.140 This chapter has set out our proposals to ensure that low-cost, good-value, private saving is accessible for all. Putting the detail of these proposals together will inevitably take time – in particular, setting up the necessary legal and administrative framework. We intend that people will be able to start contributing to the personal accounts scheme in 2012.
- 1.141 We will publish a document later this year setting out the approach we intend to take on the operation of personal accounts. This will include:
- the administration of personal accounts;
 - the structure and type of investments;
 - the process of taking a pension;
 - the exemption process for qualifying workplace schemes;
 - linking the contributions band to earnings growth;
 - transitional issues on implementing the new scheme; and
 - further detail on the information supporting personal accounts, with a detailed update on progress achieved in the Informed Choice programme and timing of future activity.

