Automatic enrolment: a success worth building on

PENSIONS POLICY INSTITUTE
PPI

PPI Briefing Note Number 117

Introduction

The Pensions Policy Institute (PPI) held an event on the 13th of February, 2020, sponsored by Standard Life and hosted by Which?, with around 60 leading thinkers in the pensions world, in order to discuss next steps for automatic enrolment. The event included speeches from **Stephen Timms, MP** (Chair of the Work and Pensions Select Committee), **Baroness Jeannie Drake, CBE** (original Pensions Commissioner) and **Chris Curry** and **Jamie Jenkins**, co-chairs of the 2017 automatic enrolment review. The initial policy has been fully rolled out and has brought around 10 million people into pension saving, however there are concerns about the 9.5 million workers who were found ineligible for automatic enrolment[1] and the almost 5 million self-employed[2] people in the UK, of which, only around 15% were saving into a pension in 2017/18.[3] There are also concerns that those who are saving into a pension might not be saving in sufficient amounts to achieve an adequate retirement income. The event attendees considered how to build on the success of automatic enrolment in order to ensure that those who might benefit from saving into a workplace pension are enabled to begin, or to continue, doing so, and that individuals are supported to make contributions at a level sufficient to provide an adequate income but not so high that they reduce working-life disposable income to an unaffordable level. The attendees also considered how to protect those who might not benefit from saving into a private pension from being pushed into saving.

The attendees were asked to consider responses to three questions:

- **Question1:** What are the successes of automatic enrolment and what could have been done better?
- **Question 2:** What needs to be considered when implementing the 2017 automatic enrolment review recommendations on the age of eligibility and earnings band, and over what timeline should they be implemented?
- **Question 3:** What outstanding issues still need to be addressed, and what are the potential means for addressing them?

This Briefing Note summarises the discussion which took place at the event in response to each of the three questions and lists the main priorities which the attendees believe policy should focus on over the next few years. **The below narrative reflects the views of various participants and does not necessarily reflect the views of the PPI.**

Question1: What are the successes of automatic enrolment and what could have been done better?

There was agreement that automatic enrolment has been a successful policy

Automatic enrolment has been successful in encouraging mass participation in pension saving. The number of active pension savers (in both the public and private sector) has grown from around 11m in 2012 to around 19m in 2018.[4] It has also been successful in enrolling the group it was specifically targeting: employed lower earners. Of all income groups, those earning between £10,000 and £20,000 experienced the greatest rise in participation between 2012 and 2018, from 34% to 81%, a 142% increase.[5]

The gradual implementation of automatic enrolment is part of the key to its success

The phasing of contributions softened the financial impact on both employers and employees, and staging allowed for the policy to be tested on larger employers before being rolled out to smaller employers.

The reaction from both employers and employees has been positive

Compliance has been high among employers, partly as a result of a successful communications campaign. Opt outs among employees have remained low, at around 9% (2018/19),[6] demonstrating the power of inertia. Automatic enrolment is leading to a national conversation about pensions and saving, helping to create a social norm for pension saving.

There is now a thriving DC market in the UK

The introduction of automatic enrolment, during a reduction in private sector Defined Benefit provision, has resulted in a significant increase in the number of savers in Defined Contribution (DC) schemes. The number of active DC savers grew from around 5.5 million in 2012 to over 13 million in 2019.[7] As a result of auto-

Figure 1: Net pay vs. relief at source

Net pay arrangements deduct pension contributions from pay before applying income tax. In net pay arrangements full tax relief at the highest marginal rate is automatically applied to the pension contributions of tax payers.

Relief at source arrangements deduct 80% of an individual's pension contribution from their salary after deducting income tax and then reclaim 20% tax relief on all contributions from HMRC on a monthly basis. Those who pay higher rate tax, must apply separately to HMRC for any tax relief owed above the 20% rate.

matic enrolment there is now a large and successful DC market within the UK.

Automatic enrolment has highlighted infrastructure, tax and policy issues with the current pension system

The introduction of automatic enrolment has highlighted several existing problems while also creating some new ones.

The net pay vs. relief at source issue is exacerbated by automatic enrolment

Those on net pay arrangements who earn less than the tax-free personal allowance of £12,500 (2019/2020) do not receive any tax relief on their pension contributions, while those contributing through relief at source arrangements receive relief, regardless of their income level (Figure 1).

While those in net pay arrangements received less tax relief prior to automatic enrolment, the anomaly affected fewer people as most savers had incomes above the tax-free personal allowance.

Arguably this issue should have been picked up earlier and resolved as many savers are now missing out on Government contributions to their pots.

Infrastructure issues have become more visible

People are being automatically enrolled and then changing jobs, and, as a corollary, accumulating pension pots with different providers. A large number of small pots can cause administrative difficulties for providers and are less cost-effective to manage. They may also lead to problems for individuals who may struggle to keep track of all of their pots but might find transferring them difficult and costly, especially if they change jobs frequently. There needs to be a long-term plan to tackle the problem of small pots and the difficulty of transferring.

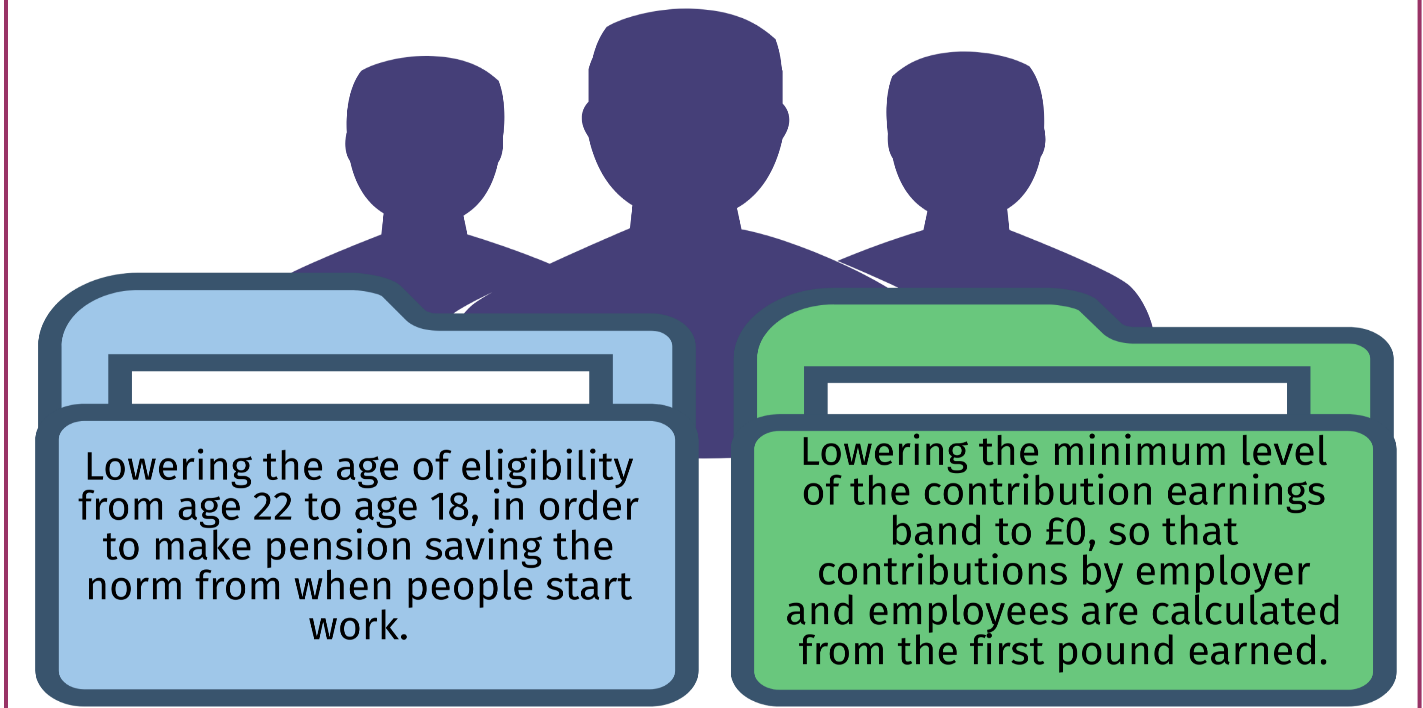
Automatic enrolment has highlighted low member financial capability

The high levels of inertia have helped automatic enrolment to be a success, but have highlighted low levels of engagement and financial capability among pension savers. This knowledge gap is less likely to lead to negative outcomes during the saving phase, though may result in lower levels of contributions. However, those saving into DC schemes will need to make complex decisions when accessing their savings which will significantly impact retirement outcomes. More work should be done on ensuring that members are capable of making informed financial decisions about pension saving.

There needs to be more balance in reducing charges

Automatic enrolment highlighted the variation in member-borne charges between DC schemes and the potential for some people to be

Figure 2: two recommendations of the 2017 automatic enrolment review



enrolled into a high-charging scheme which would significantly erode their savings and, ultimately, reduce their retirement income. In response, the Government introduced a 0.75% charge cap, in 2015, on default strategies used for automatic enrolment (excluding transaction costs). The charge cap has succeeded in bringing charges down across the DC market, but is a fairly blunt tool and could hinder some providers from investing in complex assets (such as illiquids) which may produce better overall outcomes, net of charges. It is worth revisiting the charging debate and further exploring how to get the balance right. The Department for Work and Pensions will be reviewing the cap later this year.

In 2017, the Government held a review, supported by an independent advisory group to consider how to build on the success of automatic enrolment for the future. The review put forth several reform proposals for automatic enrolment, two of which are described in Figure 2.

The Government has agreed to implement the recommendations during the mid-2020s but this has resulted in some younger people and lower earners missing out on pension saving, higher levels of contributions, or both. These proposals should be implemented as quickly as practically possible.

Women continue to experience poorer pension saving outcomes than men

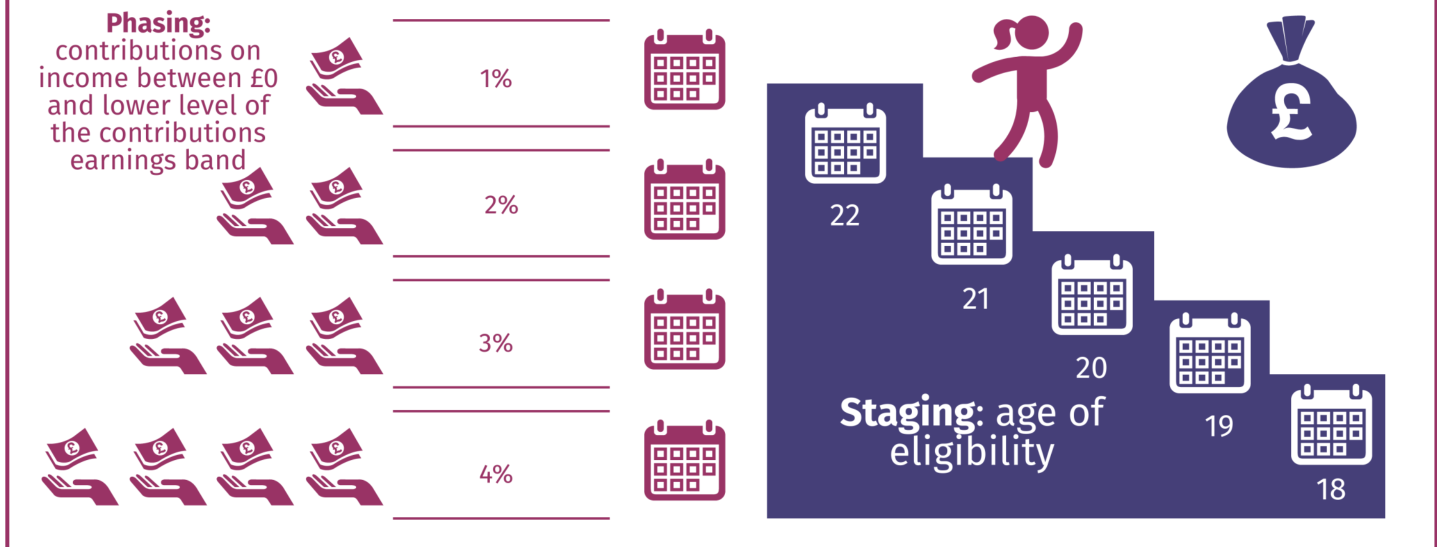
Despite the introduction of automatic enrolment, women are saving less, on average, into their pensions than men, as are carers, disabled people and people from some ethnic minority groups. More needs to be done to ensure that equality issues are ironed out and that people with different needs and characteristics are able to benefit from pension saving.

Question 2: What needs to be considered when implementing the 2017 automatic enrolment review recommendations on the age of eligibility and earnings band, and over what timeline should they be implemented?

There is a balance between maintaining the momentum, and not implementing too quickly

Both reducing the age of eligibility and reducing the lower level of the contributions earnings band to £0 represent an increased cost to employers and employees. Softening the impact could reduce the chances of employees opting out and employers struggling financially.

The impact could be softened by staging the changes, for example, reducing the age of eligibility by one year at a time, from age 22 to age 18. The reduction in the lower level of the contributions earnings band



could also be phased in, either through reducing the band in stages until it reaches £0, or by phasing in the level of contributions required in oncome below the current band minimum, from 1% to 4% for employees, and similar phasing for employers (Figure 3). The increase in contributions above the lower band could also be phased in with rises to the minimum wage, or other changes to income, so that members do not see a reduction in their pay. The policy could also be applied subsequent to the complete roll out of Universal Credit, so that the combined impact on lower earners can be assessed.

On the other hand, phasing and staging mean that many will forgo making contributions for longer than they would have done if the policies were introduced immediately. Immediate introduction would help to maintain the momentum of automatic enrolment and pave the way for future contribution rises which are likely to be necessary if people are to achieve adequate retirement incomes from pension saving. The current low opt-out rate suggests that current levels of inertia are high, and that people might not opt out in significant amounts under an increase in contributions.

An increase in contribution levels may have a significant impact on lower earners

One way of mitigating the potential impact on lower earners is to require contributions below the earnings band, and for those aged between 18 and 22, from employers only. Alternatively, or in addition, employers could be required to continue contributing on behalf of employees who opt out as a result of these reforms. Though this would represent an increased cost to employers.

Appropriate notice should be given before implementation, and research should be undertaken

Regardless of the approach, the changes need to be consulted on prior to implementation and both employers and employees need to be notified in advance, given a full explanation of the purpose of the policy, and given time to prepare.

These changes are likely to affect particular industries more than others, and research on this impact should be conducted prior to policy design.

For lower earners who stay in but find they have less disposable income during working life, there could be knock on impacts on the use of credit which leads to higher debt down the line. There needs to be research on the behaviour of lower earners in order to understand possible behavioural reactions to the changes and steps taken to mitigate these.

The changes could open up opportunities for education

These changes, particularly, the reduction of the age of eligibility, could allow for “teachable moments” with younger people, when they will be more open to financial education interventions.

Figure 4: People in certain groups are more likely to be ineligible for automatic enrolment

Question 3: What outstanding issues still need to be addressed, and what are the potential means for addressing them?

The three main outstanding issues are coverage, engagement and adequacy

Coverage: automatic enrolment is excluding certain groups

People in certain groups are more likely to be ineligible for automatic enrolment, in particular: the self-employed, those in multiple jobs (with each job earning less than £10,000pa) and some carers whose responsibilities limit their ability to work (Figure 4). While many of those in traditional employment are benefiting from automatic enrolment, a large group of society, that engages with the labour market in a more flexible way, is not benefiting from these reforms and may be less likely to achieve an adequate retirement income.

Now that automatic enrolment has been so successful with the majority group, work needs to take place to ensure that all members of society who are earning income or contributing unpaid services to society (such as carers) are also given the opportunity to save sufficiently for retirement.

Automatic enrolment has highlighted the lack of engagement from scheme members

There is a balance to be struck between engaging people in a manner which enables informed decision-making and engaging them when they are unprepared or incapable of navigating complex options. It needs to be recognised that inertia has worked very well and that it would be risky to try to engage younger people and those with lower levels of financial capability without ensuring that these interventions will not lead to poor decision-making, in the form, for example, of opting out or making poor investment decisions.

On the other hand, low levels of engagement put members at risk of contributing insufficient amounts to meet their desired retirement income, or of struggling with decisions at the point of accessing pension savings and during retirement.

The optimum level of engagement for different members needs to be identified and pursued by policy-makers and industry.

Engagement can be encouraged through the use of the upcoming mid-life financial M.O.T., which could be designed to take place at several times during the life-course, rather than just one.

Pensions dashboards could also help both with engagement and informed decision-making, by providing people with the tools they need to understand how decisions today will affect their income in retirement. Dashboards could also prove to be a tool which helps deferred members and those with multiple small pots to engage with their entire portfolio of pension saving.

Digital interventions such as messaging, apps which encourage saving, and digital guidance and advice

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should be harnessed as part of the campaign to increase engagement.

Though automatic enrolment has been highly successful, people are still not contributing enough to achieve an adequate income

While some lower earners will be able to maintain working-life standards of living in retirement on income from State Pensions and benefits, the majority will need to top up State Pension income with private pension income (or income from another source) in order to achieve an adequate standard of living in retirement. In a few cases, people may be able to achieve an adequate income through contributing 8% of band earnings to a pension throughout their working life, but the vast majority will need to make higher levels of contributions in order to achieve adequacy. Now that automatic enrolment is fully rolled out, it is time to start exploring methods for increasing contribution levels, while keeping in mind that steep or sudden rises could lead to opt outs from members, and/or to contributions becoming unaffordable.

Some options for increasing earnings in a phased, or gentle way include:

- Phasing band earnings down, as mentioned in question 2;
- Introducing flexible contribution rates, for example, providing people with a personalised flat-rate minimum contribution, which reflects the amount they can afford; and,
- Introducing, on an opt out basis, Save More Tomorrow (SMaRT) a scheme from the United States, which involves employees committing in advance to increases in contributions when wages increase. This would require revisiting regulations.

Contribution increases need to be phased in for different groups, and the phasing needs to reflect the risks of particular groups opting out as a result of increases.

Implementing the 2017 proposals should be the main priority

While the above areas need attention, the 2017 review proposals need to be implemented first, in order to provide a firm policy base on which to build. Other areas of urgent focus include:

- The small pots problem, which could be addressed through, for example, a pot-follows-member or aggregator scheme;
- The data provided by schemes and asset managers to the regulator needs to be more transparent, especially regarding the relationship between costs and charges;
- What the role of tax relief should be in the new environment of pension flexibilities;
- Whether a pensions commission should be established in order to link pensions policy with broader social issues.

The attendees were asked to vote on the top three policy priorities going forward

The most important policy priority going forward is implementing the 2017 automatic enrolment review recommendations.

The next most important policy focus is addressing the problems associated with accumulating multiple small pension pots.

Three policy areas tied for third place: increasing self-employed pension saving; implementing SMaRT on an opt out basis; and, creating a comprehensive framework for managing savings and income at and during retirement.

1 The Pensions Regulator (TPR) (2020) *Automatic enrolment declarations of compliance report, January 2020*
2 Office for National Statistics (ONS) (2019) dataset: EMP14: Employees and self-employed by industry
3 DWP (2019) *Automatic Enrolment evaluation report 2019*
4 ONS (2019) *Workplace pension participation and saving trends: 2008 to 2018,* Table 1.1
5 ONS (2019) *Workplace pension participation and saving trends: 2008 to 2018,* Table 1.6
6 DWP (2019) *Automatic Enrolment evaluation report 2019*
7 PPI Modelling

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