PENSIONS POLICY INSTITUTE

# The impact of the NEST contribution limits and restrictions to transfers



## Introduction

There is currently an annual limit on contributions to the National Employment Savings Trust (NEST) and transfers into or out of NEST before retirement are very limited. The Government has recently issued a call for evidence on the impact of both the annual contributions limit and the transfer restriction, outlining a number of proposals for lifting some or all of the restrictions.

## The background to NEST

Auto-enrolment was introduced from October 2012 for all employees, aged between 22 and the state pension age, who earn more than £8,105 per year (£9,440 from April 2013) and are not participating in a workplace pension scheme. Under auto-enrolment employers select a pension scheme for their employees.

The National Employment Savings Trust (NEST) was designed to support auto-enrolment and to ensure that employers could access a pension scheme. As a result, NEST must accept any employer and must offer good value. There is an annual contribution limit of £4,400 for total employee, employer and Government contributions combined, and restrictions on individuals transferring pension funds into and out of NEST except for annuity purchase, where a pension is shared through a divorce settlement or where an individual has been in an occupational pension scheme for less than two years.

Auto-enrolment is being introduced in stages[1]. Larger employers are currently auto-enrolling their employees. Employers with fewer than 250 employees in their PAYE scheme will auto-enrol from April 2014 onwards.

### Chart 1: Proposed options for removing restrictions

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**Contribution limit - currently set at £4,400**

- Remove annual limit at the end of implementation (February 2018)
- Increase baseline contribution limit
- Fixed % of members must not breach the limit over the course of a year

**Transfer restrictions – currently it is not permitted to transfer funds into and out of NEST with some specific exceptions**

- Remove all restrictions at the end of implementation
- Allow NEST to take part in automatic transfers of small pots
- Allow individuals to freely transfer pots in and out of NEST
- Enable NEST to accept bulk transfers
- Allow bulk transfers, as above, but only up to a set maximum value

Source: DWP (2012) ***Supporting Auto-enrolment***

## Rationale for the contributions limit and transfer restrictions

NEST was designed to meet the needs of those groups whose needs are not currently met by commercial providers; low to moderate earners, in particular, and smaller employers. The initial intention was that the introduction of NEST should not lead employers to abandon their existing good quality schemes or affect the existing market of providers, much of which was providing pensions for employers and individuals outside of NEST's target market.

As NEST has been funded by loans from central Government it was perceived that competition with existing pension providers could be unfair, and have a detrimental impact on the pensions market as a whole.

To reduce competition, a limit on contributions and restriction on transfers into and out of NEST were put into place. It was considered that these should not prevent NEST from meeting the needs of its target market of low and moderate earners. But they would prevent employers who already had pensions from transferring existing schemes into NEST.

## Subsequent market developments

Other providers have since started to provide low cost pension schemes comparable to NEST.[2] However, these schemes are not subject to the same contribution limit and restriction to transfers, so provide competition to existing traditional providers as was originally feared from NEST. This reduces the potential market for NEST and, as a result, could increase the cost for members of NEST, who are more likely to be in its low to medium earner target market. In addition to a 0.3% Annual Management Charge (AMC), NEST currently charges a contribution charge of 1.8%, which is expected to be removed once the set up costs have been met.[3] If fewer employers and employees use NEST, it will take longer for these set up costs to be met and NEST members will be required to pay the contribution charge for longer.

Subsequent policy developments

DWP has recently published plans to develop a model of automatic transfers of small pots to a new employer's scheme.[4] This would mean that where someone changes job and they have accrued a small pension pot with their current employer, this will be transferred to their new employer's pension scheme. This would mean that employers who use NEST would not currently be able to accept or make transfers.

DWP consultation

Consequently, DWP has published a call for evidence[5] outlining proposed options around both contributions and transfers (Chart 1). DWP analysis suggests that, with a contribution rate of 8% and contributions paid on earnings from the lower limit of £5,564, earnings in excess of around £60,000 per year would be required to exceed the annual contribution limit.[6]

However, individuals may need to save more than the minimum contribution levels in order to achieve adequate retirement incomes. The contribution limit can impact on different types of individuals.

## Chart 2: Required saving to hit target replacement rates

| | Decile of earnings distribution | | | | |
|---|---|---|---|---|---|
| | 1st | 3rd | Median | 7th | 9th |
| Target replacement rate | 70% | 70% | 67% | 60% | 60% |
| Man with full NI history – age 25 in 2017 | £400 (4.5%) | £1,100 (8.4%) | £1,900 (10.0%) | £3,000 (10.9%) | £7,400** (22.4%) |
| Self-employed man – age 25 in 2017 | £400 (4.5%) | £1,100 (8.4%) | £1,900 (10.0%) | £3,000 (10.9%) | £7,400** (22.4%) |
| Target replacement rate | 70% | 70% | 70% | 67% | 60% |
| Woman with caring breaks – aged 25 in 2017 | £200 (3.7%) | £900 (10.0%) | £2,600 (18.5%) | £4,500* (22.2.%) | £8,200** (25.7%) |
| Woman with caring breaks and no prior saving – age 40 in 2017 | £400 (7.6%) | £1,400 (14.6%) | £3,500 (24.8%) | £6,000* (28.6%) | £10,700** (32.4%) |

Bold figures denote average annual savings (£s) required to reach the target replacement rate. *indicates contributions that exceed £4,400 in some * or all** years. Figures in brackets denote Saving rates as % of band earnings.

***Contribution limit***

The PPI has estimated the average annual contributions that individuals with different working and saving histories, and different earnings levels, will need to achieve their target replacement rate pension income.[7] Higher earning individuals need a lower replacement rate than lower earning individuals in order to reach their target retirement income. This analysis is based on the Government's proposals for a single-tier pension and assumes nominal annual 6% investment returns.[8]

Chart 2 presents the average annual contributions for different individuals. The individuals are assumed to have age-specific earnings—for example, the median earning man is assumed to have the median earnings of 25 year olds when he is 25. As earnings vary from year to year, contribution levels will actually vary from year to year. This means that each individual has a range of contribution levels. Where an individual's range takes them above £4,400 in some years this is indicated with an asterisk, and in all years this is indicated by two asterisks.

- A man aged 25 years in 2012 with a full NI history. He would need average contributions of between £400 (earning at the 10th percentile) and £7,400 (at the 90th percentile) of his band earnings each year, depending on his income, to reach his target replacement rate in retirement. The analysis shows that a £4,400 limit is sufficient for the median earning man (with a salary range of between £19,500 and £30,000) and at the 7th decile, (with a salary range of £24,000 and £41,000 depending on age). However, it may constrain higher earners; 9th decile earners, where the salary range is between £31,500 and £62,500 depending on age, would be constrained in most years. The analysis shows that a self-employed man age 25 in 2017 would be affected in the same way.

- A women aged 25 in 2017 with two caring breaks. The £4,400 limit is sufficient if she is a median earner, (with a salary range of between £18,000 and £25,000 depending on age) but may constrain higher earners with these characteristics.
- A woman aged 40 years in 2017, with no previous savings history, and two caring breaks The £4,400 is sufficient if she is a median earner (with a salary range of between £18,500 and £25,000 depending on age) but may constrain higher earners with these characteristics. This could mean she has limited flexibility to alter her savings pattern year by year.

Overall the analysis shows that the contribution limit is sufficient for most people on low to median incomes to achieve their target replacement rate in retirement. However, people who are older when they are auto-enrolled and have no saving history are more likely to be constrained by a £4,400 limit.

In practice, the extent to which the contribution limit restricts choice will depend on several factors.

***Whether companies have employees who would breach the NEST contribution limit***

DWP's analysis has suggested a salary of £60,000 as the level at which employees are likely to breach the contribution limit[9]; however, this is based on the assumption that total employees' and employers' contributions in all years will be no higher than 8% of the employee's salary, from the lower limit of £5,564. In practice, people may wish to make higher contributions, meaning that individuals on lower salaries than £60,000 may breach the contribution limit.

If employers have employees who would breach the contribution limit for NEST, they may not be prepared to use two pension schemes and may, for this reason, reject NEST as an option. There are concerns that this will lead to reduction of choice of pension schemes for employers and, ultimately, poorer value for employees.

While higher earners are more likely to breach the contribution limit, an employer's decision to reject NEST as an option will affect all employees working for that employer, including those lower paid employees targeted by auto-enrolment and NEST.

Chart 3 compares the impact of NEST charges, including the contribution charge, and the impact of a 0.77% annual management charge (AMC), the average annual management charge for existing schemes[10], based on a continuous contribution of £1,000 per year (similar to that required by a low earner). This analysis assumes that the NEST contribution charge continues indefinitely.

If the rate of return on the funds were equal, an individual who saved £1,000 per year in NEST after 20 years would lose 6% of their fund value due to charges compared to a reduction in fund value of 10%, if they saved in a pension that had an Annual Management Charge of 0.77% per year.

***Whether employers have an existing pension scheme***

Some employers may have an existing scheme and choose to ensure that this scheme meets the requirement for auto-enrolment, rather than switching to NEST. Research conducted before the introduction of auto-enrolment found that, among those employers who already had some active members in a workplace pension scheme 49% planned to enrol non-members and new employers into existing schemes[11].

***Whether employers are willing to run more than one pension scheme***

Research around employers' intentions suggests that some would be willing to run more than one pension scheme. For instance, before auto-enrolment was introduced, 8% of employers indicated that they would enrol non-members and new employees into a combination of schemes[12].

***Transfer restrictions***

The Government has recognised that the accumulation of small pension pots by individuals can be problematic, as it can lead to duplication of administration charges and make it more difficult for individuals to know the value of their pension. In most cases, NEST will be unable to accept and make transfers and, unless the rules are changed, the adoption of NEST by many employers would perpetuate this issue, as employees are unable to transfer their small pots into or out of NEST.

Conclusions

***Contribution limit***

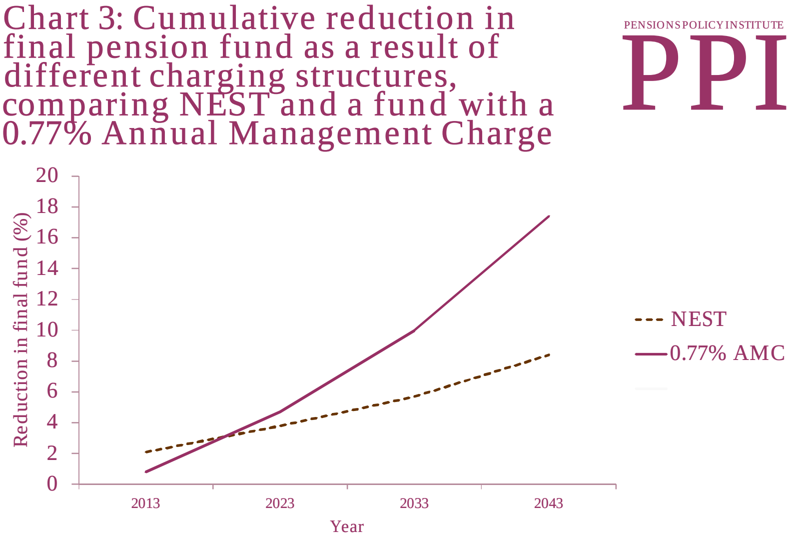
The PPI's modelling shows that most low to median earners would be able to meet their target replacement rate by saving in NEST, without being affected by NEST's contribution limit. However, the PPI's analysis also shows that some higher earners would not be able to meet their target replacement rates if they were saving in NEST, because they would be constrained by the NEST contribution limit. It is also possible that some employees who have not yet started saving in a pension when first auto-enrolled could be constrained by the contribution limit.

Where employers have a workforce that consists of both higher and lower earners, the ability of those employers to use NEST as a sole pension provider is likely to hindered by the existence of the contribution limit. This may be a particular problem for small employers where it may not be viable to run a separate pension scheme for a relatively small number of higher earners.

***Transfer restrictions***

Under current policy NEST cannot receive transfers in or out. This restriction was originally intended to stop employers from transferring their entire workforces in bulk to NEST, thus undermining the existing pensions market.

Chart 3: Cumulative reduction in final pension fund as a result of different charging structures, comparing NEST and a fund with a 0.77% Annual Management Charge




Based on a contribution of £1,000 per year from 2012 onwards. This assumes a nominal rate of return of 6% per annum for both funds

The Government has recognised that individuals accumulating lots of separate small pension pots is inefficient as it can lead to duplication of pension charges and therefore poor outcomes for members, and has proposed that an individual's pensions pot should follow them automatically when they move jobs. Currently, NEST would not be able to receive such transfers.

The Government could consider relaxing the restrictions on individuals making transfers into and out of NEST when an individual wishes to transfer a pension as a result of a job move or a desire to consolidate several small pension pots. If it is concerned that wholesale large transfers into NEST could undermine the stability of the wider pension market the Government may wish to consider keeping some restrictions on large scale bulk transfers into NEST.

[1] The Pensions Regulator, ***Table 1: List of staging dates by PAYE scheme size or reference***
[2] NOW: Pensions and B & CE have low charges similar to NEST: NOW: Pensions has an AMC of 0.3% and an administration charge of £1.50 per month while B & CE's People's Pension has an AMC of 0.5%.
[3] NEST (2012) ***Low charges for future members of NEST***
[4] DWP (2012) ***Improving transfers and dealing with small pension pots***
[5] DWP (2012) ***Supporting automatic enrolment***
[6] DWP (2012) ***Supporting automatic enrolment,*** p.12
[7] The target replacement rate represents the rate of pension benefits related to what people feel is necessary for them to replace the standard of living they had while working
[8] If returns are lower, individuals may need to make larger contributions each year. Chart 2 assumes that individuals purchase a level single life annuity, at projected unisex annuity rates.
[9] DWP (2012) ***Supporting automatic enrolment,*** p.12
[10] Based on ABI's figure for average annual AMC for existing schemes in ABI news release, 12 July 2012
[11] DWP (2012), ***Employers Pension Provision Survey 2011,*** p.114, [12] p.115

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