PPI Submission to the Work and Pensions Select Committee: Automatic enrolment in workplace pensions and the National Employment Savings Trust (NEST)

Summary

I. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

II. This submission provides the PPI's written evidence to the Work and Pensions Select Committee inquiry on automatic enrolment into workplace pensions and the National Employment Savings Trusts (NEST) announced in July 2011.

III. The introduction of auto-enrolment into pension saving in the UK from 2012 is one of the most significant policy reforms proposed to private pension saving by any Government. The policy aims to increase both <u>the number</u> of individuals saving in private pensions and to increase <u>the total amount</u> of private pension saving.

IV. International evidence of auto-enrolment reforms into private pension saving in New Zealand suggests that auto-enrolment may significantly increase the number of people saving into a private pension. Estimates vary depending on opt-out rates, but PPI analysis undertaken in 2007 projected that the number of people saving into a work-based pension in the UK (either into NEST or into an existing pension scheme) as a result of the reforms could increase by an additional 4 to 9 million. Allowing for the recent proposed changes to the auto-enrolment threshold, this is similar to the Government's most recent estimates that there could be between 5 and 8 million new savers in work-based pension schemes, of which 2 to 5 million are expected to be in NEST.

V. There is more uncertainty about how the introduction of auto-enrolment will affect the total amount of private pension saving in the UK. The reforms will increase some employers' labour costs due to the new legal requirement for employers to auto-enrol their eligible employees into a qualifying existing pension scheme or into NEST and to contribute at least 3% of a band of earnings as an employer pension contribution.

VI. It is difficult to predict how employers will react to the increased cost of employer pension contributions that some employers will face as a result of the reforms. Some employers may pass on the increased costs to consumers through higher prices or to shareholders through lower profits, while other employers may pass on the costs to employees either by reducing wages or by choosing to auto-enrol their employees into a less generous pension scheme than the one that they currently offer to existing employees.

VII. The Pensions Policy Institute has published projections of the possible impact of the introduction of auto-enrolment into private pensions saving on the total annual amount of pension contributions going into private pensions schemes (both NEST & existing pensions) in the UK. The research considered four possible scenarios:

1. In the most optimistic scenario, in which all employers with good qualifying pensions schemes auto-enrol into their existing pension schemes, total private pension saving in the UK could be £10 billion higher than in the absence of the auto-enrolment reforms (in 2006/7 earnings terms) by 2050.
2. In a cost control scenario in which employers with existing good pensions schemes continue to spend the same amount on pensions but simply spread it more thinly across more employees after auto-enrolment, by 2050 total pension contributions in the UK could be £5 billion higher than in the absence of the reforms (in 2006/7 earnings terms.)
3. In a modelled employer response scenario in which some employers auto-enrol into existing good schemes, others make changes to their existing schemes or auto-enrol into NEST, by 2050 total pension contributions in the UK could be £2.5 billion higher than in the absence of the reforms (in 2006/7 earnings terms.)
4. In the most pessimistic scenario, in which over time, all employers "level-down" the generosity of their pension scheme and only offer the legal minimum of a 3% employer contribution, by 2050 total pension contributions in the UK could be £10 billion lower than in the absence of the reforms (in 2006/7 earnings terms.)

VIII. The analysis shows that there is a wide range of possible outcomes from the Government's reforms in terms of the impact on the total level of private pension saving in the UK. There are two main factors that will determine the success of the reforms in both increasing the number of individuals saving for their retirement in a private pension and also in increasing the total amount of private pension saving in the UK:

- The extent to which individuals opt-out of pension saving after being auto-enrolled will to a large extent determine the number of people who will be saving for their retirement in a private pension. The decision by an individual over whether to opt-out is likely to be influenced by a range of factors including the affordability of the employee's pension contributions, the extent of personal/ household debt and the extent to which there is a clear message that it pays to save in a private pension.

- Employers' responses to auto-enrolment will determine the extent to which the reforms increase or decrease the total level of private pension saving in the UK. If employers auto-enrol eligible employees into existing good pension schemes where they have them, then there is likely to be a positive increase in the total amount of private pension saving in the UK as a result of the reforms. By contrast, if employers with existing good schemes were to start to reduce the generosity of the employer contributions to those schemes to the level of the legal minimum of 3% of band salary, then we could see a substantial reduction in the total amount of private pension saving in the UK.

IX. As a result, policymakers should focus attention on:

a. Getting a better understanding of the factors that are likely to influence individuals' decisions to opt-out of pension saving once auto-enrolled.
b. Getting a better understanding of what will determine employers' likely responses to the reforms and what can be done to encourage employers to auto-enrol their employees into existing good qualifying pension schemes where they have them.

X. In terms of the implication of the reforms on NEST and on the overall shape of the private pensions market:

- Decisions made by employers about whether to auto-enrol their employees into existing good pension schemes or into NEST will also affect the future shape of the private pension market. PPI Projections suggest that the size of the assets held in NEST are likely to be substantial by 2050, and could range from one-fifth of the total private pension funds under management to one-half by 2050 depending on employers' responses to the reforms.

- PPI analysis suggests that that if the policy objective remains that NEST is intended as a saving vehicle for low to median earners, then most low to median earners are unlikely to be constrained by a contribution cap of £3,600 (in 2005/6 earnings terms) and are likely to be able to achieve their target replacement rate within this cap. However, higher earners may not be able to achieve their target replacement rate solely through saving into NEST.

Introduction:

1. This submission considers the following questions in four different groups:

   Effects of auto-enrolment on individuals:
   - Estimated opt-out rates, including the possible impact of NEST if the numbers auto-enrolled are significantly lower than predicted.
   - How self-employed people, part-time, temporary, casual and agency staff will be treated under auto-enrolment; and the equality implications.
   - The extent to which auto-enrolment is likely to achieve the desired behavioural change in terms of encouraging people to make a provision for retirement.

   Effects of auto-enrolment on businesses:
   - Likely impact of auto-enrolment on businesses, especially small and micro-businesses.
   - Arrangements for phasing and staging the introduction of auto-enrolment.

   Wider effects of auto-enrolment:
   - NEST's potential market share and the possible effects on other providers.
   - Likely impact of the limitations placed on NEST, including the contributions cap and the ban to transfer in.

   Auto-enrolment communication strategy:
   - DWP communications strategy for introducing auto-enrolment and provision of advice and support to employers and employees.

2. This response is based on a number of PPI research outputs published between 2007 and 2010:
   - ***PPI Submission to the DWP Review: Making auto-enrolment work*** (2010).
   - PPI Briefing note: ***What should qualify as earnings for auto-enrolment?*** (2008).
   - PPI Report: ***Will Personal Accounts increase pension saving?*** (2007).
   - PPI Briefing note: ***What should be the contribution cap for Personal Accounts?*** (2007)
   - PPI Report: ***Increasing the value of saving in Personal Accounts: rewarding modest amounts of pension saving*** (2007).

3. This written evidence is intended as a contribution to the policy debate about the potential impact of the Government's private pension reforms. The information contained in this response should not be relied upon by individuals or their advisers in making decisions relating to their own personal circumstances.

4. It is important to highlight that many of the findings from these research outputs related to the policy that was proposed at the time these research outputs were published. However, most of the findings are relevant to the questions set out in this inquiry and, where possible, it is highlighted in this response how subsequent policy changes introduced after the research was published may have had an effect on the issue analysed in each specific question.

5. It is therefore helpful to compare the provisions regarding auto-enrolment and NEST (originally called Personal Accounts) legislated in the Pensions Act 2008 and outlined in previous Government White Papers, and those proposed in the 2011 Pensions Bill, currently under consideration by Parliament. Table 1 compares such provisions.

Table 1: provisions legislated in the Pensions Act 2008 and previous White Papers, compared to those proposed in the 2011 Pensions Bill

Aspect	Pensions Act 2008 and previous White Papers	Proposed in 2011 Pensions Bill
Auto-enrolment earnings threshold	Gross earnings of £5,035 (2006/07 earnings terms)	Gross earnings of £7,475[1] (2011/12 earnings terms)
Band of qualifying earnings	Gross earnings from £5,035 to £33,540 (2006/07 earnings terms)	Gross earnings from £5,715 to £38,185[2] (2010/11 earnings terms)
Minimum Contributions	3% of band earnings from the employer, 4% from the employee, 1% from Government through tax relief[3]	3% of band earnings from the employer, 4% from the employee, 1% from Government through tax relief[4]
NEST charging structure	Annual Management Charge (AMC): 0.3%[5]	AMC: 0.3% Contribution charge until the loan to set up NEST is repaid: 1.8% on total contributions.[6]
Staging of auto-enrolment	No provision	From October 2012 to September 2016, depending on employer size[7]
Phasing in of contributions	No provision	11/2011 to 09/2016: 2%, with a minimum 1% from the employer. 10/2016 to 09/2017: 5%, with a minimum 2% from the employer. 10/2017 onwards: 8%, with a minimum 3% from the employer.[8]

[1] As proposed in the 2011 Pensions Bill

[2] DWP (2011) ***Automatic Enrolment and Workplace Pension Reform – the facts***

[3] It is estimated that the tax relief offered by the Government on private pension contributions is roughly equivalent to a 1% contribution from the Government for basic rate taxpayers. However, for higher rate taxpayers the value of the relief will be higher than 1%.

[4] As above.

[5] As proposed in: DWP (2006) ***Personal Accounts: a new way to save.***

[6] Announced on 24 November 2010. ***Press Release: NEST Corporation Sets NEST Charging Level***

[7] See DWP (2011) ***Automatic Enrolment and Workplace Pension Reform – the facts.*** Larger employers will begin auto-enrolling their entitled employees first and then smaller employers will follow on a mostly monthly basis.

[8] As above.

Effects of auto-enrolment on individuals:

6. Estimated opt-out rates, including the possible impact of NEST if the numbers auto-enrolled are significantly lower than predicted. The Pensions Bill 2011 proposes to set the earnings threshold from which employees must be auto-enrolled in workplace pensions at £7,475 per year (in 2011/12). Auto-enrolled employees will have the right to opt-out. In addition, people who are not eligible for auto-enrolment, because their earnings are below the £7,475 threshold, or those aged between 16 and 22 years old, will have the right to opt-in to NEST.[9] The self-employed will also have the right to opt-in.

7. Auto-enrolment in workplace pensions is likely to increase the number of people saving into a pension. However, the proportion of people who decide to opt out, as well as the proportion of people that are entitled and decide to opt in, will determine the actual amount of people saving into a workplace pension once the reforms are fully rolled out.

8. Estimating participation rates is complex given that the UK will become the second country in the world in introducing a national system of auto-enrolment into private pension saving with the option to opt-out. The other example, New Zealand's KiwiSaver, went live on 1 July 2007. There are however, significant design differences between the two schemes that may make comparisons difficult.[10] In particular, in KiwiSaver individuals are only auto-enrolled when starting work for the first time, or when changing jobs and the level of voluntary opt-ins to KiwiSaver through employers or providers has been substantial.

9. Recent estimates from New Zealand's Inland Revenue, show that the opt-out rate, calculated as the number of people who opted-out divided by the number of people who were auto-enrolled, has been around 33% in the first three years from 2007/08 to 2009/10.[11]

10. In 2007, the PPI published some research estimating the impact of different participation rates on the possible total number of people saving into workplace pensions and NEST. It is important to note that the auto-enrolment earnings threshold used was £5,035 (in 2006/07 earnings terms), as proposed by the Government at the time, rather than the current £7,475 (in 2011/12) proposed in the Pensions Bill 2011.

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[9] Provided their earnings are at least equal to the lower limit of the earnings band: £5,715.

[10] See PPI (2007) ***Will Personal Accounts increase pension savings?***, p.37.

[11] Inland Revenue (2010), conclusions. This figure was calculated using the total number of people who were auto enrolled and remained auto-enrolled (1,241,677) and the total number of people who were auto-enrolled but opted-out (604,705). The rate results from: 604,705/(1,241,677 + 604,705).

11. This research used three possible scenarios,[12] which were intended to illustrate the possible range of outcomes from the Government's proposed reforms, rather than being forecasts:
    - Optimistic Scenario: 20% of eligible employees opt out of work-based saving, in line with the top range estimate made by the Government at the time,[13] and 0.9 million self-employed and 0.9 million other individuals opt in.
    - Central Scenario: 33% of eligible employees opt out of work-based saving, in line with the central case estimate made by the Government at the time, and 0.75 million self-employed and 0.6 million other individuals opt in. The 33% opt out rate is similar to the three-year equivalent for New Zealand's KiwiSaver.
    - Pessimistic Scenario: 50-60% of eligible employees opt out of work-based saving, in line with the lower estimate made by the UK Government (50% opt out) and the lower participation estimate made by the New Zealand Government for KiwiSaver (60% opt out), and 0.5 million self-employed and 0.3 million other individuals opt in.

12. Under an optimistic scenario, it was estimated that there could be around 9 million new savers in work-based pension schemes and NEST in the UK. Under a central scenario, there could be an additional 7 million new savers. Finally, under a pessimistic scenario, the estimated number of new savers in work-based pension schemes and NEST would be around 4 to 5 million.

13. Latest estimates by DWP suggest that the change in the auto-enrolment threshold from the original £5,035 of gross earnings (in 2006/7 terms) to £7,475 of gross earnings (in 2011/12 terms) will decrease the number of people eligible for auto-enrolment by up to 0.6 million.[14] The Government's recent estimates show that there could be between 5 and 8 million new savers in work-based pension schemes, of which 2 to 5 million are expected to be in NEST.[15]

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[12] The scenarios did not include employees and employers in the public sector. See PPI (200) ***Will Personal Accounts increase pension saving?***

[13] DWP (2006) ***Security in retirement: Regulatory impact assessment.***

[14] DWP (2011) ***Pensions Bill Summary of Impacts,*** p.12.

[15] DWP (2011) ***Pensions Bill, Workplace pension reform legislation. Impact Assessment*** p.47.

14. How self-employed people, part-time, temporary, casual and agency staff will be treated under auto-enrolment; and the equality implications. Under current legislation the self-employed are not required to be auto-enrolled. However, they may opt-into NEST and pay voluntary employee contributions at the statutory minimum of 4% of band earnings and receive 1% from Government through tax relief.

15. Following the auto-enrolment review,[16] it has been proposed in the Pensions Bill 2011 that individuals with earnings above £7,475 (in 2011/12 earnings terms) will be auto-enrolled but that they will pay contributions on a band of earnings in excess of £5,715. This is different to the original provisions set out in the Pensions Bill 2008, which set the auto-enrolment trigger and the lower limit of the band earnings at £5,035 (in 2006/07 earnings terms). This means that people with earnings between £5,715 and £7,475 may not benefit from being auto-enrolled and saving into a pension. This could specifically apply to part-time, temporary, casual and agency staff who are more likely to have a lower earnings than full-time employees and may consequently fall within this income bracket. An estimated 600,000 individuals have earnings between £5,715 and £7,475,[17] and under the proposed policy changes these individuals would not automatically benefit from an employer contribution that would increase their retirement income, unless they opt themselves into the system.

16. The extent to which auto-enrolment is likely to achieve the desired behavioural change in terms of encouraging people to make a provision for retirement. Whether auto-enrolment will achieve the expected behavioural change of increasing the number of people saving into a pension will depend on a number of factors:
    A. Opt out rates: it is difficult to anticipate the expected opt out rates as the UK will be only the second country in the world, after New Zealand, in incorporating a national system of auto-enrolment into private pension saving with the option to opt-out.[18] The international evidence from New Zealand's KiwiSaver and 401K schemes with automatic enrolment in the US suggest that we can expect a large increase in the numbers of new pension savers. However, there is a question about whether this will lead to an increase in total pension saving.

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[16] Johnson, P., Yeandle, D. and A. Boulding (2010) ***Making Automatic Enrolment Work***

[17] See Johnson, P., Yeandle, D. and A. Boulding (2010) ***Making Automatic Enrolment Work,*** p.100.

[18] It is important to highlight that there are important differences in the design of both systems of auto-enrolment.

B. The number of people who opt into NEST: current legislation stipulates that the self-employed can opt in and make voluntary contributions at the statutory employee minimum of 4% of band earnings and receive an extra 1% contribution from the Government through tax relief. Also, those employees between 16 and 22 years old and between State Pension Age and 75 years old, can opt in and benefit from the employers contribution of 3% of band earnings.[19] It is also hard to estimate how many eligible people in this group will decide to opt-in. Official estimates,[20] used in previous PPI work, show that the number of the self-employed who could opt into NEST could vary from 0.5 million to 0.9 million.

C. Employers' reaction: it is also hard to predict how employers will react to the reforms, which will entail an increase in labour costs for some employers as employers will need to auto-enrol their qualifying employees and they will need to contribute at least 3% of a band of earnings. As a result, employers may decide to pass on this increase in costs either by increasing prices or reducing profits – in this case consumers or shareholders would lose out from the reforms. Employers could also reduce wage settlements or reduce the generosity of their pension scheme to try to offset some of the extra costs related to the increased participation in pension schemes following auto-enrolment – in this case employees may be affected.

Effects of auto-enrolment on employers:

17. Likely impact of auto-enrolment on businesses, especially small and micro-businesses. Employers have shown different levels of awareness and possible reactions to the legislated provisions regarding auto-enrolment in workplace pensions. A survey carried out by DWP in 2009 showed that around 44% of all private sector employers had some awareness of the reforms. Larger employers were more likely to be aware of the reforms than smaller employers; almost three-quarters (73 per cent) of employees worked for an employer who had heard about the reforms. Awareness was particularly low among employers with no workplace pension scheme and among those with only shell schemes (workplace pension schemes without any members among current employees).[21]

18. Employers could pass the increased labour costs due to having to auto-enrol their qualifying employees in a number of ways:
    - to consumers through higher prices,

[19] Provided they have earnings of at least £5,715.
[20] DWP (2006) ***Security in Retirement: Regulatory Impact Assessment,*** paragraphs 2.50, 2.56, 2.58.
[21] DWP (2010) ***Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey,*** p.2.

- to employees through lower wage increases,
- to shareholders or owners through lower profits,
- to pension scheme members, through lower contributions, if they already contribute more than the minimum 3% required.

19. According to the survey carried out for DWP, 31 per cent of employers said they would absorb costs through profits / overheads, 18% said they would absorb costs through lower wage increases, 16% through restructuring or reducing the workforce and 15% through increased pricing.[22] The survey also found that among those employers currently contributing at least three per cent to their largest workplace scheme, 90% expected to retain the same contribution rate for existing members after the reforms, while 4% expected to contribute more than their existing rate and 6% expected to contribute less.[23]

20. Depending on how employers finally react to the reforms, it is possible to project different outcomes in terms of the total amount of pension saving, which can be measured by the total pension contributions (from the employer, the employee and the government through tax-relief) once auto-enrolment is fully in place.

21. In 2007, the PPI analysed the possible impact of employers' behaviour on total pension contributions once auto-enrolment is fully in place.[24] Before discussing the results and their insights for this response, it is important to note the differences in the provisions regarding auto-enrolment and NEST that were in place at the time of the research and those currently in place, as shown in Table 1.

22. The PPI analysis considered four possible scenarios of employer behaviour. The scenarios were stylised and some were deliberately extreme to show the full range of outcomes from the policy. All the scenarios were based on an overnight introduction of the reforms in 2012:
    - An 'employers enrol on existing terms' scenario. This scenario assumed that employers already offering a pension scheme with at least a 3% employer contribution decide to keep the scheme open on the same terms as would be the case without reform. They therefore pass on the cost of the increased participation resulting from auto-enrolment to consumers, shareholders or to employees through lower wages, but they do not reduce pension contributions.

[22] DWP (2010) ***Employers' attitudes and likely reactions to the workplace pension reforms 2009: Report of a quantitative survey***, p.4.
[23] As above, p.80.
[24] PPI (2007) ***Will Personal Accounts increase pension saving?***

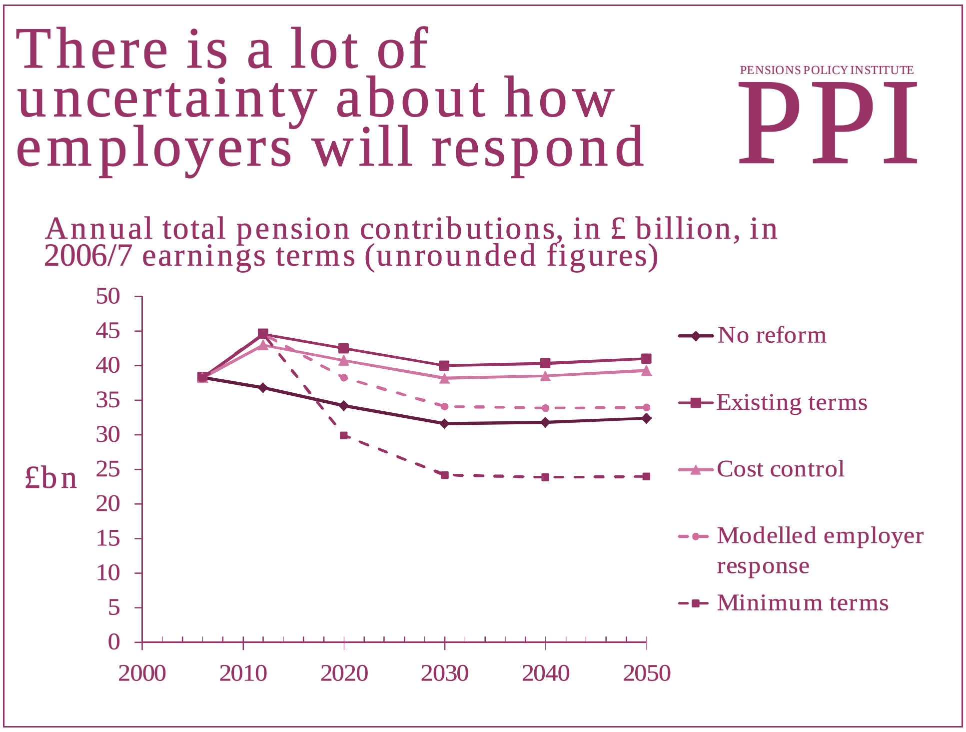
- A 'cost control scenario' in which employers with good pension schemes hold the total amount that they spend on pensions constant and pass on the costs of the reforms through lower pension contributions. In this scenario, employers who contribute more than the 3% minimum into a pension scheme reduce their pension contributions to maintain the same overall level of expenditure on pensions as before the reforms were introduced. Employers who do not already offer a pension scheme (or who offer less than a 3% employer contribution) are assumed to contribute the 3% minimum. Therefore, they are assumed to pass on the costs in one of the other three ways: to shareholders through reduced profits, to consumers through higher prices or to employees through lower wages.
- A 'modelled employer response scenario.' Employers are assumed to act in the way suggested by a survey on employers' attitude to auto-enrolment conducted by Deloitte.[25] The survey was chosen because, at the time of the analysis, it was the most recent survey on employers' attitudes to auto-enrolment. In this scenario, employers are assumed to act in different ways, with some keeping their scheme open on current terms and others closing their scheme to new members or reducing their contribution levels.
- An 'employers enrol on minimum terms' scenario. This is an extreme scenario as it assumes that all employers contribute a minimum of 3% of a band of earnings for all newly enrolled employees. Employers who currently offer schemes with more than a 3% contribution are assumed to keep their current contribution rates for existing members. However, in the long term, as people switch jobs, the minimum 3% contribution becomes the norm.

23. In the most optimistic scenario in which all employers auto-enrol their qualifying employees under existing terms, total annual pension contributions in the UK could be £10 billion (in 2006/7 earnings terms) higher than without the reforms by 2050. By contrast, in the most pessimistic scenario in which all employers make only the minimum contribution of 3% of band earnings, total annual pension contributions could be £10 billion (in 2006/07 earnings terms) lower than without the reforms by 2050.

24. If employers treat pensions like a budget and control costs total annual pension contribution could be £5 billion higher (in 2006/07 earnings terms) than without the reforms by 2050. If employers respond in line with a survey of likely attitudes, total annual pension contributions could be £2.5 billion higher than without the reforms by 2050 (Chart 1).

[25] Deloitte (2006) ***Pension reform in the workplace.***

Chart 1:[26]



25. The analysis shows that auto-enrolment policy will be far more successful in increasing the total level of pension saving if employers with existing good pension schemes auto-enrol eligible employees into those existing good pension schemes. Therefore, the policy should be designed to make it as simple as possible for employers with good pension schemes to use those schemes to fulfil their new legal obligations.

26. Arrangements for phasing and staging the introduction of auto-enrolment. The staging of auto-enrolment will imply that people employed by large employers will be auto-enrolled and will start to save into a pension much earlier than people employed by small employers. In addition, the phasing in of the employer contribution will mean that all auto-enrolled employees will receive a lower employer contribution than the minimum 3% of a band of earnings until October 2017. These changes may affect the value that different individuals will get from saving into a pension. Specifically, these changes may affect older employees, who have fewer years to accumulate savings into a workplace pension or into NEST than younger employees.

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[26] For more details on the data for this chart see PPI (2007) ***Will Personal Accounts increase pension saving,*** Table 8, p.24.

27. PPI research in 2010, building upon research published in 2007, estimated the value of saving into a pension scheme similar to NEST for different types of individuals. 'Value' was calculated by modelling the internal rate of return individuals would get from being auto-enrolled into a scheme similar to NEST.[27] The internal rate of return is the nominal interest rate that an individual receives on their contributions, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and post-retirement means-tested benefits.

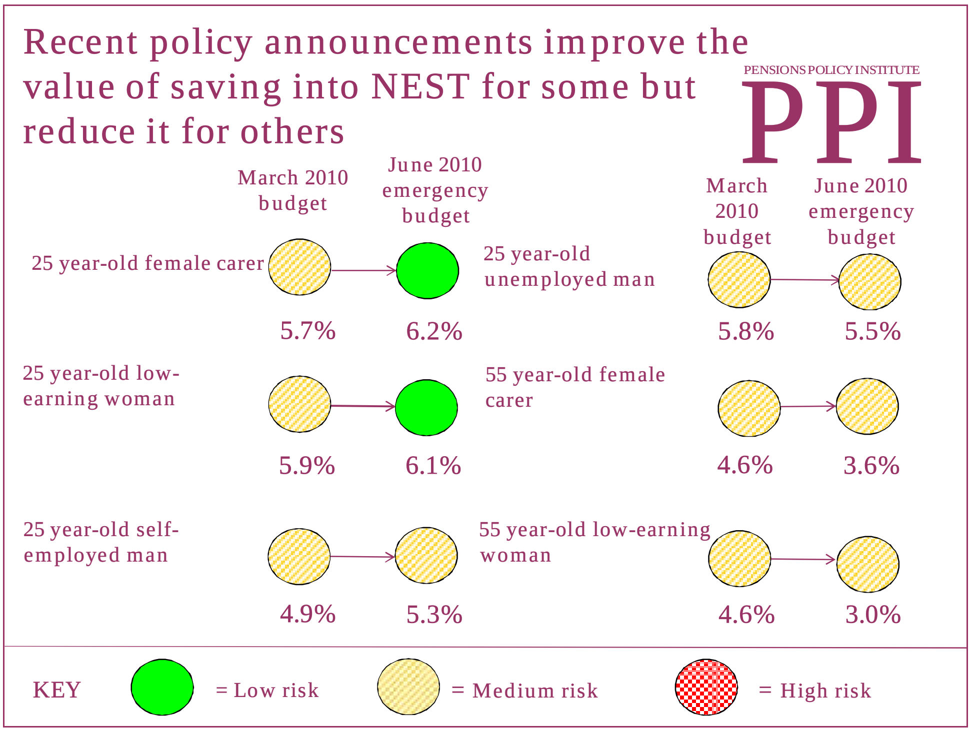
28. This analysis looked at the impact of the system as of June 2010, which included the staging in of auto-enrolment and the phasing in of employer contributions as well other changes announced in 2010:
    - The uprating from 2011 of the Basic State Pension by the 'triple lock' of the higher of earnings growth, price inflation -the RPI in 2011 and the CPI in subsequent years- or 2.5%.
    - The indexation of SERPS / S2P in payment by CPI from April 2011.
    - NEST's initial contribution charge of 2% and an annual management charge of 0.3% per year.[28] The original analysis assumed that NEST would have a charging structure equivalent to a 0.5% per year AMC. Although in aggregate these charging structures are likely to be broadly similar in the long-run, they may have different impacts on different types of individuals.

29. It is important to note that the analysis cannot isolate the effect of the staging of auto-enrolment and the phasing in of contributions. However, it may provide an overall picture of how these changes, in addition to those announced since 2010, are likely to affect different individuals.

30. Chart 2 compares the internal rate of return (IRR) for individuals from saving into NEST under the system that was in place at the time of the last analysis in 2007 (rolled forward to 2010) with the system in place after incorporating the recent policy changes in NEST and state pension indexation announced in 2010.

[27] PPI Individual Modelling.
[28] It was subsequently announced in 2010 that NEST would have an AMC of 0.3% and a contribution charge of 1.8%. Announced on 24 November 2010. ***Press Release: NEST Corporation Sets NEST Charging Level***.

Chart 2



31. Under the system in place after the June 2010 Emergency Budget announcements, which included the staging of auto-enrolment and the phasing in of contributions, the IRR was reduced for some older individuals, while it was increased for some younger ones:
    - The IRRs of the 25 years old female carer and the 25 years old low-earning female are both increased by the policy changes.
    - However, individuals with the same characteristics but aged 55 in 2012 rather than 25 would see lower IRRs as a consequence of the policy changes.

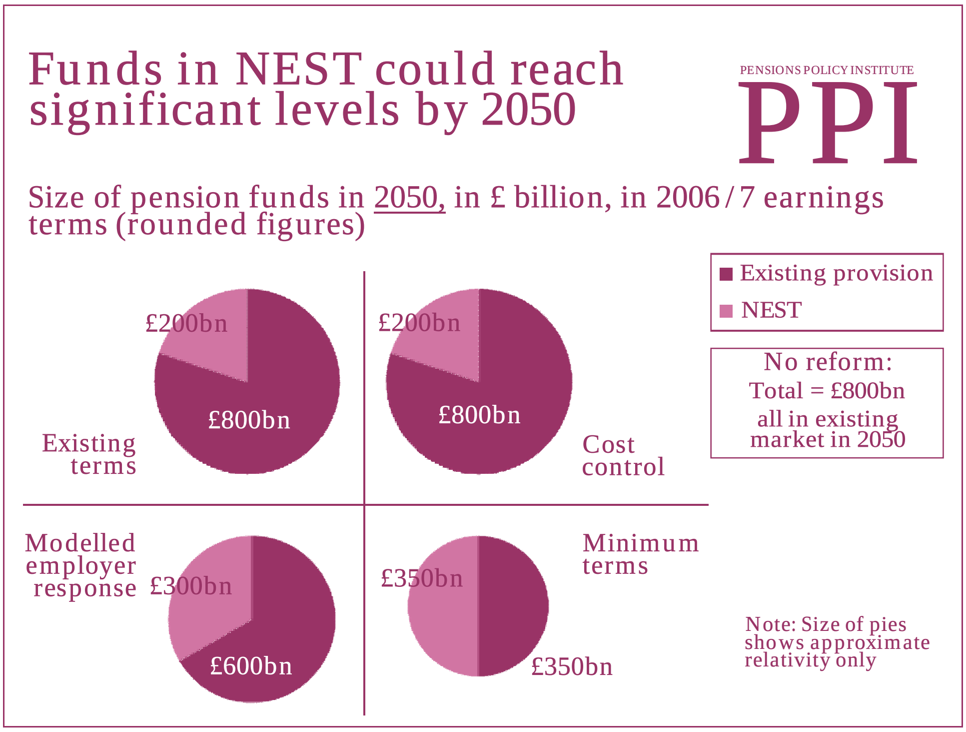
32. Although the results do not isolate the effect of the staging of auto-enrolment and the phasing in of contributions, this analysis indicates that recent policy changes could affect older individuals. Older individuals have comparatively less time to accumulate a pension pot than younger ones. In this context, the phasing in of contributions, in addition to NEST's contribution charge, reduce the total amount of contributions going to each individuals' accounts and this has a much more negative effect for older individuals than for younger ones.

Wider effects of auto-enrolment:

33. NEST's potential market share and the possible effects on other providers. The introduction of NEST is likely to affect current pension provision as employers will have a choice of auto-enrolling their employees into an existing workplace pension scheme or into NEST.

34. The PPI estimated the potential split of aggregate pension funds in existing provision and in NEST under similar scenarios as those described in paragraph 22 (Chart 3).[29]

Chart 3[30]



35. In the absence of reform, the aggregate size of pension funds is projected to reduce from £1,100 billion in 2012 to around £800 billion by 2050, in 2006/7 earning terms. This is primarily the result of the assumed decline in private sector DB schemes. All of these funds would be held in existing provision, because without the reforms NEST would not exist.

[29] Given that the analysis took place in 2007, the same caveats regarding the assumptions used that were explained in the analysis shown in Chart 1 apply for this part of this analysis. For this section, see PPI (2007) ***Will Personal Accounts increase pension saving?***, chapter 3.

[30] For a full detail of the data behind these estimates, see PPI (2007) ***Will Personal Accounts increase pension saving?***, Table 8, p.24.

36. When the reforms are introduced pension funds will be split between existing types of provision and NEST, although the aggregate size of pension funds in NEST will take some time to build up.

37. If employers enrol employees on ***existing terms*** or ***control their costs*** by reducing the average level of their voluntary contributions, the total size of pension assets held in existing types of provision could remain similar in 2050 to what is expected without reform. In these scenarios, assets held in NEST could increase to around £200 billion (2006/7 terms), representing around one-fifth of the total pension funds under management.

38. In the ***modelled employer response scenario***, NEST could represent one-third of the total assets by 2050. And, if employers ***auto-enrol on minimum terms***, the proportion of pension assets held in NEST could be a lot greater, representing as much as half of the total funds under management by 2050.

39. Likely impact of the limitations placed on NEST, including the contributions cap and the ban to transfers in. Current legislation establishes a limit on the total amount of contributions that can be made into NEST of £3,600 a year in 2005/06 terms.[31] The original intention of this contribution cap was to avoid unfair competition to existing pension provision and to ensure that NEST was used as a pension saving vehicle for low to moderate earners.

40. Current legislation also imposes a ban to transfer pension rights that have already been built up under existing provision into NEST. The limit on transfers-in is intended to reduce the potential negative impact of the introduction of NEST on existing provision. However, this policy is due to be reviewed in 2017.

41. In 2007, the PPI estimated the average annual combined pension contributions that could be needed for different types of individuals, members of NEST, to reach their Pensions Commission's replacement rate (Chart 4). The analysis assumed that NEST would achieve a 3% real investment return. If returns turn out to be lower, individuals may need to make greater contributions to achieve their target replacement rate.[32]

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[31] This is equivalent to £4,300 in 2010/11. The limit will be uprated with earnings for implementation in 2012.

[32] Employers are assumed to contribute 3% of employees' band earnings. Employees are assumed to contribute the same percentage of their band earnings from 2012 until retiring at state pension age. The analysis also assumed that workers convert their entire pension pot into a level annuity, without a spousal benefit. Since the original analysis was carried out in early 2007, it does not take into account the changes in the Pensions Act 2007 or the indexation

Chart 4[33]

Required saving to hit target replacement rates

	Decile of earnings distribution				
	1st	3rd	median	7th	9th
Target replacement rate	***70%***	***70%***	***67%***	***67%***	***60%***
Man with full NI history - age 25 in 2012	£700 (7.7%)	£1,400 (9.9%)	£1,800 (9.5%)	£2,900 (11.4%)	£5,200 (18.4%)
Woman with caring breaks – age 25 in 2012	£200 (4.5%)	£1,600 (17.5%)	£2,900 (23.1%)	£4,700 (26.4%)	£7,900 (29.3%)
Woman with caring breaks and no prior saving – age 40 in 2012	£600 (12.4%)	£2,500 (26.9%)	£4,000 (31.9%)	£6,200 (34.1%)	£10,200 (36.8%)
Self-employed man – age 25 in 2012	£1,700 (19.6%)	£2,400 (17.6%)	£2,900 (15.3%)	£4,000 (15.8%)	£6,300 (22.4%)

Bold figures denote average annual savings (£s) required to reach the target replacement rate. Figures in brackets denote saving rates as % of band earnings.

42. The analysis shows that the contribution cap of £3,600 per annum is unlikely to constrain the ability of lower and median earners to meet their target replacement rates, with the exception of the modelled woman enrolled into NEST at age 40 and with career breaks.

43. It is possible to conclude that if the policy objective remains that NEST is intended as a saving vehicle for low to median earners, then most low to median earners are unlikely to be constrained by a contribution cap of £3,600 (in 2005/6 earnings terms) to achieve their target replacement rate. However, higher earners may not be able to achieve their target replacement rate solely through saving into NEST.

Communication strategy for auto-enrolment:

44. DWP communications strategy for introducing auto-enrolment and provision of advice and support to employers and employees. The communication strategy set up by DWP will be critical to ensure that both employees and employers understand the obligations and implications of the new system. Specifically:

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of the Basic State Pension by the 'triple-lock' of the higher of earnings, CPI or 2.5% from 2011. A higher BSP will mean that the level of contributions needed to hit the target replacement rate will be lower, so the numbers in Chart 4 may be over-estimates.

[33] See PPI (2007) ***What should be the contribution cap for Personal Accounts?*** Briefing Note 38.

- Employers will need to understand what their obligations are in terms of the earnings above which they need to auto-enrol their employees and the contributions they will need to make. Employers will also need to understand that the reforms will have a cost implication for them. This is due to the fact that employers who currently do not offer a pension arrangement will be required to contribute at least 3% of a band of earnings for their auto-enrolled employees. Previous PPI research has shown that the success of auto-enrolment may vary depending on how employers react to the reforms.[34]
- Employees will need to understand what could be the consequences of remaining within a work-based pension or NEST or opting-out. Previous PPI research has shown that some individuals will be better-off if they remain opted-in, whereas some others may not receive a good value from saving into a personal pension.[35] Career patterns, life expectancy after retirement and the interaction with the tax and means-tested benefit system affect the value that individuals may get from saving into a personal pension.

[34] See PPI (2007) ***Will Personal Accounts increase pension saving?*** Chapter 2. It is important to note that this analysis was based on the system as announced in 2007 and some of the assumptions on the enrolment threshold and NEST charging structured have changed. See page 41 for a detail of the assumptions in this analysis.
[35] See PPI (2007) ***Will Personal Accounts increase pension saving?*** Also see PPI (2010) ***PPI Submission to the DWP Review: Making Auto-enrolment work.***