PENSIONS POLICY INSTITUTE

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Increasing pension saving in the UK

Introduction

The rolling out of automatic enrolment into workplace pensions from 2012 will radically change the future landscape of private pension provision in the UK. The Government's latest estimate is that there could be 9 million people newly saving or saving more into a workplace pension by the time automatic enrolment is fully rolled out in 2018.[1]

Current legislation stipulates the total minimum contribution rate from the employer, employee and the Government through tax relief at 8% of band earnings between £5,772 and £41,865 (2014/15).

With over 80% of Defined Benefit schemes in the private sector now closed to future accruals and to new members, it is likely that the vast majority of individuals will be enrolled into a Defined Contribution (DC) pension, where the level of employer and employee contributions, among other factors, will affect the chances of achieving an adequate retirement income.

For many people, contributing at the legal minimum may not be enough to achieve an adequate income in their retirement. There are a number of different policy and industry responses that have the potential to increase contribution rates and encourage people to save more for their retirement.

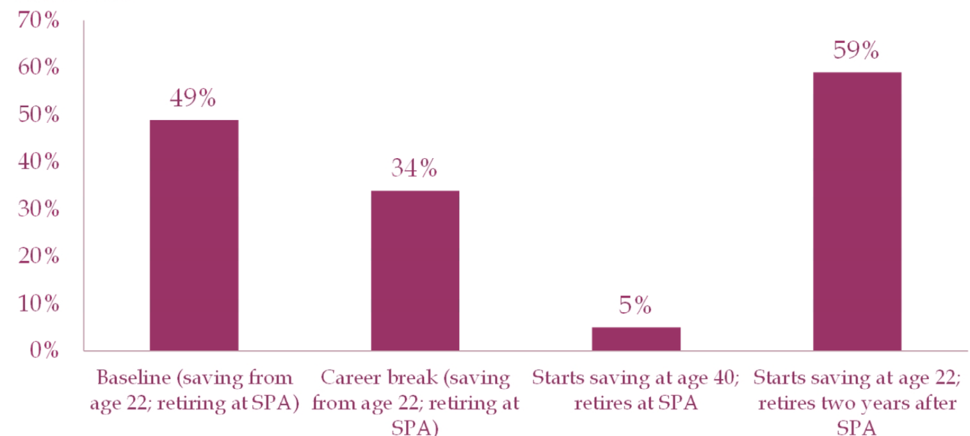
The issues covered in this Briefing Note were discussed at a Round Table event hosted by JP Morgan Asset Management, on 11 July 2014, and the note reflects some of the issues that were raised by the Round Table participants.

The note explores the factors that could affect the adequacy of retirement income and discusses the challenges that individuals and employers may face when increasing contribution rates, along with some policy and industry responses that could help to address those challenges and increase overall levels of saving.

Saving into a DC pension may not lead to an adequate retirement income

Once automatically enrolled into a DC pension, whether members and/or employers decide to contribute at the legal minimum of 8% of band earnings or more, when members start to save and when they choose to retire, among other factors including investment returns and charges, will affect a member's chance of achieving an adequate retirement income.

Retirement income adequacy can be defined as the income level that allows pensioners to replicate the standard of living they had in their working life. The Pensions Commission set benchmark replacement rates. Target replacement rates are higher for lower earners than for higher earners as lower earners may need a higher proportion of their pre-retirement earnings to be able to replicate their pre-retirement living standards. The target replacement rate for a low earner is

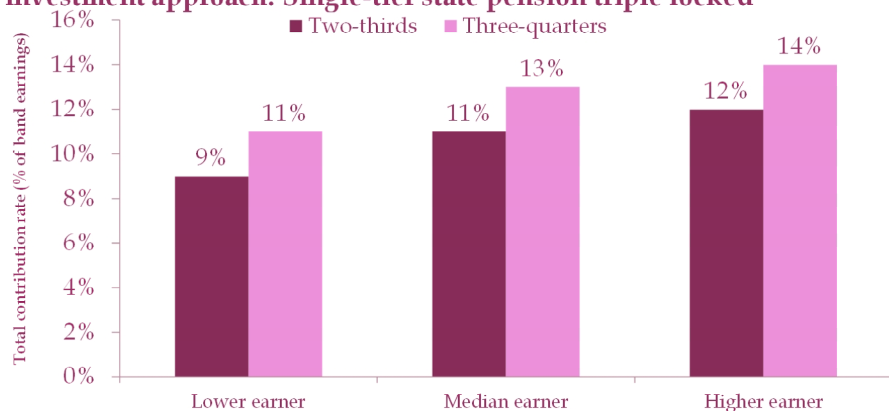


PPI Briefing Notes clarify topical issues in pensions policy.

set at 80% of pre-retirement earnings, for a median earner is set at 67%, and for a high earner is set at 50%. These target replacement rates are based on an assumption (ahead of the Budget 2014 flexibilities) that an individual uses their pension savings to provide a regular stream of income through retirement, for example through the purchase of an annuity or through a form of income drawdown.

Chart 2: the required contribution rate for a good chance of reaching a target replacement income increases with earnings

Contribution rates needed for different individuals to reach a 66% or 75% probability of achieving their target replacement income, if they start saving at age 22, retire at SPA and follow a traditional lifestyle investment approach. Single-tier state pension triple locked



Previous PPI research has shown that the probability of a median earner achieving their target replacement income with income from state and private pensions if saving from age 22 to State Pension Age (SPA) at the legal minimum of 8% of band earnings is around 49% (Chart 1). However, this reduces to 34% if the individual takes a career break from age 32 to 39 and it reduces to just 5% if the median earner starts to save from age 40.[2]

The estimates were modelled stochastically, with each individual run 100,000 times under different economic scenarios. This approach took account of the variability around investment returns and economic variables year on year, providing a more realistic measure of the uncertainty of achieving an adequate retirement income.

The probability of a median earner achieving their target replacement income increases to 59% if the individual retires two years after their SPA.

These estimates assume that members take a 25% tax-free lump sum and that they purchase a single-life annuity with the rest of their pot at retirement. The changes announced by the Chancellor at Budget 2014 are generally expected to see fewer people in future purchasing an annuity at retirement and more people withdrawing lump sums or using other forms of phased drawdown.[3]

It is also assumed that the single-tier state pension is indexed by the triple-lock of changes in average earnings, changes in the Consumer Price Index (CPI) or 2.5%, and that a traditional lifestyle approach is followed in the fund into which the individual is automatically enrolled.

Contributing more than the minimum 8% of band earnings could help individuals to achieve their target replacement rate (Chart 2).

For example, a median earner that saves from age 22 to SPA, follows a traditional lifestyle approach and contributes 11% of band earnings, could reach a 66% chance of achieving their target replacement income. If instead they contributed 13% they could reach a 75% chance. Again, when an individual starts to save and retire and whether he takes career breaks will affect the total contribution rate needed to reach a higher probability of achieving their target replacement income.

The evolution of DC coverage in the UK

DC pension provision in the UK is divided between occupational schemes arranged by the employer and group or personal pension schemes. Occupational schemes generally have a trust-based governance structure where a board of trustees runs the scheme in the interest of its members.

Group and personal pensions have a contract-based govern-

ance structure where the scheme is managed and governed by the provider, usually an insurance company, although providers are increasingly introducing independent governance committees (IGCs) following a recent OFT report into the functioning of the DC market.[4]

The Government has established the National Employment Savings Trust (NEST) as a trust-based scheme with low charges. NEST has a public service obligation to accept any employer that wants to use it to automatically enrol their eligible employees.

In addition, a number of multi-employer trust-based schemes have expanded their operations or entered the market. These are generally called Master Trusts and they tend to offer a low cost structure and independent governance.

While estimates vary, the 'accumulation' part of the DC workplace pensions market, distributed between trust-based and contract-based schemes, is generally estimated to be worth between £200bn-£300bn before the introduction of automatic enrolment.[5] The total number of active members in the different types of workplace DC schemes in the private sector was estimated at around 3.6 million in 2013.[6] This compared to around 1.4 million active members in private sector DB schemes, and a further 1.1. million active members in private sector hybrid schemes.

The closure of DB schemes in the private sector is likely to continue in the future due to, among other factors, rising longevity, investment risk and changes in legislation and regulation. Previous PPI research has suggested that by 2020 there could be less than a million active members in DB schemes.[7]

DC provision is expected to dominate the pension landscape in future and it will be divided among occupational schemes, group and personal pensions, and multi-employer/master trust schemes including NEST.

Recent PPI research exploring the impact of automatic enrolment concluded that there could be 14 million active members in private sector DC workplace pension schemes by 2030 and a total of £480 billion in assets (in 2014 earnings terms).[8]

These results are based on an assumed 15% opt-out rate from automatic enrolment, once smaller employers have staged, with employers generally keeping existing DC members at their current level of contributions rather than levelling down.

In a DC pension total savings may be affected by a range of factors including:

- the level of contributions;
- the persistency of contributions;
- the investment return achieved by the fund where contributions are invested; and
- the charges levied against the fund.

In 2013, the average (mean) size of a DC pot used to buy an annuity at retirement was £35,600 while the median was only around £20,000, meaning half of those annuitants were buying with DC pots below that value.[9] At current market rates, the average pension pot size of £35,600 could buy a fixed annuity of around £2,140 per annum.[10] If the full single-tier pension of £7,700 (2014/15) is added, and there are no other sources of pension income, this would lead to a total retirement income of around £9,840.

This is unlikely to provide an adequate retirement income for a large number of pensioners, particularly median-higher earners. Therefore, many individuals will need to increase their pension saving in future if they wish to replicate their living standards in working life during retirement.

The changes announced at Budget 2014 could see more retirees with DC pension pots using forms of income drawdown in future, which could increase their average incomes in retirement, but at the risk of some individuals running out of funds, either because their investment returns are lower than expected, or because they live for longer than anticipated.

There are challenges to increasing pension saving

In a pension landscape largely dominated by DC provision and, post automatic enrolment, inertia, some specific factors could represent a challenge to increasing pension saving, including:

- the thresholds for automatic enrolment;
- whether individuals remain enrolled into a workplace pension or decide to opt-out;
- the use of default or minimum contribution rates which may act as an anchor;
- whether individuals take career breaks;
- whether individuals are self-employed;

- as of April 2015, the ability to access DC pension savings from age 55 without any tax penalty, whether taken as an annuity or not.

The current threshold for automatic enrolment is set at £10,000 per annum from 6 April 2014, in line with the personal income tax threshold. People below the automatic enrolment threshold will not benefit from being automatically enrolled into a pension, though those with annual earnings above the Lower Earnings Limit of £5,772 are entitled to opt-in and still receive the employer contribution.

DWP estimated that around 1.3m people would have earnings in 2014/15 between the National Insurance Lower Earnings Limit (£5,772) and the 2014/15 PAYE personal tax threshold (£10,000). Under current rules these groups would be excluded from the automatic enrolment reforms unless their employer voluntarily enrolled a wider group of workers or they actively chose to opt in.[11]

As of June 2014, around 3.5 million workers have been automatically enrolled into a qualifying scheme. Strikingly though, over 4.2 million have been assessed but have not been automatically enrolled because of having earnings below the automatic enrolment threshold or their age being below 22 or above State Pension Age.[12]

There is also growing concern about the retirement provision of the self-employed. The number of self-employed people in the UK has risen from 3.4 million people in 1991 to 4.5 million people in 2014. However, the take-up of private pension saving by self-employed people has declined over the same time period. In 1991, 66% of self-employed people were members of a personal pension scheme, while in 2011 only 34% were members. This group will not be affected by automatic enrolment unless they choose to opt in to a scheme. If they opt in they can do so into a qualifying scheme for automatic enrolment, such as NEST, and benefit from the Government contribution of 1% of band earnings if they contribute at the minimum of 4% of band earnings.

Those who are automatically enrolled may decide to opt out due to different personal circumstances. DWP research with larger employers found that opt out rates in the first year of automatic enrolment were very low at 9% on average. The most common reasons for opting out given were affordability and having other financial priorities. These reasons generally applied to younger workers who feel that they cannot afford saving into a pension while having to pay for other long-term financial commitments.[13]

People may also decide to opt out because they have other types of provision for retirement, such as savings, property, etc. These reasons typically applied to older workers and higher earners. Older workers who believe they have insufficient time to build up a pension pot that would provide for an adequate income in retirement may also be more likely to opt out.

The setting of a default or minimum level of contributions at 8% of band earnings may signal to individuals, particularly the automatically enrolled population who may be less engaged, that this is the right or appropriate level of savings for them to have an adequate retirement income. There may therefore be risks attached to setting a default contribution level that suits the lower earners but leaves the median-high earners under-saving for their retirement unless this is effectively communicated to them.

Whether individuals take career breaks during their working life may also affect their chances of having an adequate retirement income. This is because they do not contribute to a pension during their break years. If their scheme has relatively high charges (including "active member discounts" or "deferred member penalties") and a period of low investment returns, members who take a career break could find the value of the fund actually diminishes during their break years. The Government has responded to a recent consultation on pension charges by introducing a charge cap of 0.75% of assets under management for default DC funds qualifying for automatic enrolment from April 2015.[14]

Finally, the Government recently announced measures introducing more flexibility to access pension pots at or before retirement.[15] From April 2015 individuals aged 55 and over will either be able to withdraw their pot as a cash lump sum at retirement paying their marginal income tax rate (including keeping their 25% tax free lump sum), buy an annuity, or choose an alternative income drawdown product (or a combination of all the above).

Chart 3: options for saving more (1)
Contribution structures

	Pros	Cons
Increasing minimum legal contributions (employer and/or employee)	• Simple to understand, could be implemented through an extended period of phasing. Most direct lever.	• Could increase opt-out rates unless compulsion also introduced (e.g. Australia)
Alter the structure of minimum contributions in line with adequacy findings (e.g. median earners at 12%).	• Could target higher contributions at those who need them most for adequacy and avoids defaulting the lower earners into over-saving.	• If included higher employer contributions for median-higher earners could be seen as unfair.
Encourage *or* require more employers to offer matching contributions.	• Allows employers to target their employer contributions at the workers who value them most. • Common practice for employers with existing DC schemes (67% of employers offer these in NAPF Annual Survey 2013).	• May be affordability concerns for some employers. • May benefit some groups who are already saving more voluntarily (leading to deadweight).
Harnessing inertia through anchoring/auto-escalation	• Members could pre-commit to future increases (annual or with pay rises) • Members could be defaulted into a higher contribution rate and be allowed to "opt-down".	• More successful with combined with good member engagement and workplace seminars (US).

The measures provide for more flexibility than the current rules. This could encourage some individuals to save more, but could encourage others to access their pension savings before they even reach retirement. Individuals will need to make an informed choice about how they access their savings if they are to avoid paying high marginal tax rates (for example if they wish to access their pension as one or a number of lump sums) and avoid consumer detriment.

Some policy options could help increase pension saving

Automatic enrolment may be successful in ensuring that people save into a pension because of inertia. But inertia may lead all but the most engaged employees to save at the statutory minimum. Evidence from New Zealand, where automatic enrolment was introduced in 2007, shows that a vast majority of members do remain saving at the minimum.

Against this background, options to increase pension saving could come from:

- the Government;
- employers;
- Industry and providers; or
- individuals (via the use of information and incentives).

Chart 3 shows a range of options for increasing pension saving through changing contribution levels directly. For example, the Government could consider increasing minimum pension contributions over time (either for individuals, employers, or both).

However, there is a risk that higher contribution rates could lead people, particularly lower earners, to opt out because members would feel they could not afford higher contribution rates. This may undermine the aim of the automatic enrolment policy of encouraging more people to save.

Similarly, younger workers may have competing priorities, including paying down debt and student loans, and saving for a deposit for a house. Employers may also be more con-

cerned with ensuring their workers are saving enough for different purposes and needs (including through, for example, corporate ISAs and share incentive schemes), rather than just through a workplace pension scheme where their money is effectively locked away until age 55.

To ensure members do not opt out in large numbers the Government could consider a form of compulsion, either on employees or employers, as currently exists in Australia. However for some groups, again particularly the lower earners, this could lead to forced over-saving during their working years and having lower levels of lifetime welfare overall.

Alternatively, the Government could establish higher minimum contribution rates only for median-higher earners, who are at greater risk of not saving enough for an adequate income in retirement, such that lower earners would not need to opt out due to affordability concerns. Or, the Government could build on framing effects and inertia to set higher default contribution rates when members are automatically enrolled, but still allow them the option to "opt-down" (rather than opt out) to the minimum of 8% of band earnings.

Both of these approaches could be set out in regulations and would require a choice between the balance of employer and employee contributions and how the higher minimum or default level of contributions is administered.

They do however imply a stronger role for the state in determining how much different groups of workers should be saving to provide themselves with adequate incomes in retirement. This could be seen as overly prescriptive, particularly in light of single-tier state pension reforms which have deliberately moved away from the state trying to provide higher replacement incomes for

Chart 4: options for saving more (2)
Incentives and Engagement

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	Pros	Cons
Early access to retirement savings	• May encourage members to save more if they are worried about their savings being "locked-away". • Existing examples, e.g. in New Zealand, where can access own contributions for housing deposits and at times of financial hardship.	• Risk of members saving more, or saving the same, but having less left for retirement – could be counter-productive. • Budget 2014 changes have already moved some way in this direction.
Tax incentives	• Some political parties considering restructuring tax-relief to a single-rate – could make it simpler to explain e.g. you put in £3 we match with £1 (e.g. a 25% single rate).	• Typically those that understand incentives that use them. • Restructuring may not target the groups who are most at risk of inadequate outcomes (median-higher earners).
Education and Engagement	• Builds on the improved communications and engagement from employers that has taken place with AE implementation. • Budget 2014 changes are also likely to require greater member engagement from mid-late 40's onwards.	• Previous initiatives (e.g. informed choice) have not been successful. • Issue with who is responsible – Government, providers, employers, regulators, advice agencies and consumer groups?

higher earners, with the abolition of the State Second Pension from April 2016 onwards.

More voluntary employer or industry led approaches could include employers offering their employees matching contributions, so that those that are motivated to save most for retirement have a stronger incentive to do so.

This may be more attractive to employers than higher contributions for all workers as they are targeting the rewards at those who value them most. Research with employers with existing schemes has found that matching contributions can be popular (used by 67% of employers) and benefit from relatively high levels of take up of the maximum available contributions (48% of scheme members were on the maximum).[16]

There are other possible interventions based on behavioural economics that could lead people to save more without risking increasing opt-out rates. For example, "Save More Tomorrow" (SMarT) initiatives pre-commit scheme participants when they join a scheme to increase pension contributions after each future pay rise.

Once signed up, the individual no longer has to make an active decision on increasing pension contributions, as it happens automatically. In one US 401k (DC) scheme with SMarT features, employees increased their pension contributions from 3.5% to 13.6% of salary over a four and a half year period.[17] In 2009 around 59% of large US companies' DC schemes had SMarT features.[18]

Potential challenges with introducing auto-escalation could include the economic and labour market environment at the time, as ideally these pre-commitment devices are introduced at a time of steady earnings growth, and the administrative changes that would be needed to payroll systems and software. If a large number of employers were demanding the option to use auto-escalation with their employees the payroll industry would be more likely to respond positively. However, many larger employers have just been through a period of overhauling their payroll processes to implement automatic enrolment.

One final option to consider could be widening the earnings band over which pension contributions are made. The minimum requirement for automatic enrolment is to make 4% employee contributions and 3% employers contributions on "band earnings" (between £5,772 and £41,865 in 2014/15.) by 2018. Some employers, particularly those with existing pension provision prior to automatic enrolment, use "total earnings" instead.

This strategy could be particularly effective for median-higher earners who may be able to afford slightly higher contributions. For example, for an individual earning £30,000 per annum, a 4% contribution on band earnings would be £81 a month, compared to £100 a month on total earnings.

Once the employer contribution and tax-relief is included, their 8% contribution would be £162 a month on band earnings compared to £200 a month on total earnings. This change alone would increase their total pension contributions by nearly 25%.

Among options that involve incentives and engagement (Chart 4), the Government could consider further flexibility to allow access to pension savings before age 55. For example, in some countries an individuals own contributions can be accessed to help with the costs of a housing deposit or in times of financial hardship.[19] Early access provision may especially incentivise younger people (ages 20-29), women, and men and women in low income groups, who have traditionally been amongst the groups least likely to be saving enough for their pensions.

Australia and New Zealand, among others, allow DC members to withdraw their own contributions earlier under some specific provisions. However, there is an associated risk that people who access some of their funds earlier may not have enough savings at retirement to secure an adequate retirement income. These early access provisions can also be very complex and time consuming to administer.

Individuals could make better use of incentives to save more. For example, tax relief on pension contributions was originally implemented to increase pension saving. However, the system of tax relief is still poorly understood by many savers and most tax-relief currently goes to higher rate tax payers.[20]

Education and engagement could also help individuals to increase their awareness of how much they need to save to achieve an adequate income in retirement.

The Government's 'We're all in' automatic enrolment campaigns have managed to increase the general public's awareness about workplace pensions, with 80% of individuals found to be aware of the adverts.[21]

Summary

There are pros and cons across all different options. Increasing the legal minimum contributions may increase pension saving but there is a risk that some members may opt out if they decide they cannot afford higher contributions. UK employers that have set higher minimum contributions have tended to experience a slightly higher opt-out rate than those that have set contribution at the legal minimum.[22]

More targeted approaches to raising contribution levels, SMarT initiatives and auto-escalation may be effective in using forms of inertia and defaults to increase pension contributions. However, without active member engagement individuals may still not know if they are saving enough for their retirement.

Incentives and engagement could increase participation and understanding of how much people need to save for retirement. However, further early access carries risks of people running down savings before retirement, and incentives such as tax relief (as currently structured) are poorly understood. A simplification of the regime and some more specific targeted incentives (e.g. a 5 or 10 year pension saving bonus for younger savers) could help to boost engagement.

Finally, education and active member engagement may be expensive to deliver, as it would entail some kind of campaign from employers, industry and the Government.

At this stage none of the political parties have set out a firm view on whether minimum contributions to workplace pensions should be increased during the next Parliament. The current focus is on the successful implementation of automatic enrolment (particularly the staging for smaller employers from now until 2018) and the completion of phasing to get all individuals up to a minimum total contribution of 8% of band earnings.

A formal review of the automatic enrolment programme is scheduled for 2017, and it seems likely that the government of the day will wish to use the review to at least consider if any further measures to increase pension savings are desirable.

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J.P.Morgan Asset Management

The PPI is very grateful to J.P. Morgan Asset Management for hosting a Round Table event at which these issues were discussed. The round table was attended by representatives from pension schemes, pension providers, Government, consumer groups and investment managers.

The PPI is also grateful for the input from the participants who attended the Round Table event. Editing decisions remain with the PPI who takes responsibility for any errors or omissions.

For more information on this topic, please contact
Mel Duffield 020 7848 3751
mel@pensionspolicyinstitute.org.uk
www.pensionspolicyinstitute.org.uk

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