A flexible approach to the NPSS

Introduction

In June 2005 PPI Briefing Note 21 assessed the New Zealand government's proposals for the KiwiSaver. Since then, the Pensions Commission has proposed a National Pensions Savings Scheme (NPSS), referring to the KiwiSaver as a comparable model[1].

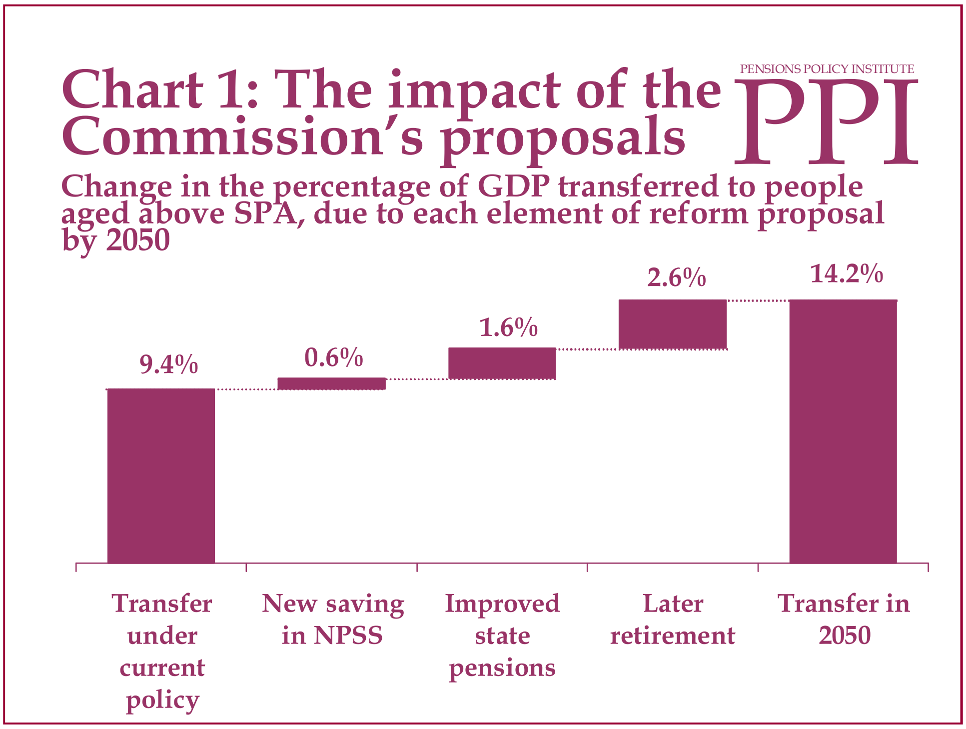
KiwiSaver is of interest as it is the first proposal for a national auto-enrolment savings scheme and far enough ahead in practical implementation to offer some lessons for the UK. The PPI has taken a closer look, interviewing officials, politicians, providers, employers and others in New Zealand preparing to introduce KiwiSaver in April 2007. Prior to a longer research paper, this Briefing Note covers two suggestions as the UK Government considers the NPSS and alternative proposals.

1. The NPSS is a very prescriptive pension product. A more flexible savings product could satisfy wider policy aims and be more attractive to would-be savers.
2. The NPSS requires major change overnight for Government, providers, employers and individuals. A phased implementation, working off existing infrastructure, would be less risky but could still achieve a similar result.

How important is the NPSS?

Before considering alternative designs for the NPSS, it should be put into context with other policies aimed at improving retirement incomes. As the Pensions Commission's analysis shows, the NPSS would be a small contributor compared with policies to extend working lives and to reform state pensions (Chart 1)[2].

This suggests that policy work on the NPSS should not crowd out work on the other issues – and that any particular NPSS design proposal does not have to be fully in place immediately.



PPI Briefing Notes clarify topical issues in pensions policy.

1. Emphasise savings, not pension

All employees would be automatically enrolled into the NPSS (or allowable alternative) and employers of those employees who do not opt out are compelled to contribute. The benefit from NPSS has to be taken as a pension; like other UK pension products it would not be available before age 55 and must be annuitised or drawn down by age 75.

The KiwiSaver also introduces automatic enrolment for employees. Employers have to be a conduit for employee contributions, but are not compelled to contribute. Although most of the KiwiSaver benefit is locked away until age 65, part or all can be taken out before then in specific circumstances, including to put down a deposit for a first home.

KiwiSaver literature does not use the word "pension", but emphasises the general benefits of saving to individuals. The policy aim is to[3]: *…support a cultural change in New Zealanders' attitudes toward savings to increase self reliance and forward planning; and, to help create a financial buffer for New Zealand households through the building up of assets, reducing debt dependence and giving people increased financial independence and flexibility, particularly in retirement.*
… help to obtain a change in behaviour for people who are not currently saving or are under-saving and to get them into the habit of long-term saving. The Government's role in this scheme is to facilitate, rather than coerce, saving….

The policy aim of the Pensions Commission's NPSS is much more prescriptive and focuses only on pension income[4]:*…to seek to ensure that the median earner achieves an income replacement rate of at least 45%.*

A more flexible approach to helping people with general savings seems attractive in the UK context, where exhortations to save more in pensions have not worked. It could tie in with other policies, for example the "ownership society" aims of the Child Trust Fund and Savings Gateway.

Of course, if money is taken out of a fund early, then there will be less money for retirement income. But if more people are attracted to save in the first instance, and some saving sticks, then retirement income should be higher for more people than the status quo.

2. Gradual implementation, not 'big bang'

The significant differences in the practical implementation of KiwiSaver and NPSS are set out in Table 1. The KiwiSaver in New Zealand is an easier implementation challenge than any new scheme would be in the UK: New Zealand has a small population with little existing occupational pension provision. It has a PAYE system able to make monthly remittances and has a well-established independent body giving help to people making financial decisions. But the approach to KiwiSaver is *…to minimise compliance costs for employers and to work off existing processes where possible*[5]. Employees are auto-enrolled into KiwiSaver only on job changes, employer contributions are not compulsory and providers can offer existing products subject only to the simple KiwiSaver contributions and benefit rules. Despite this approach, practitioners still see implementation as a challenge in New Zealand.

The NPSS proposes a fundamentally different approach that affects every worker, requires new systems and institutions to govern and regulate, and changes the operation of industry providers and employers from day 1. There are two significant sources of risk in the NPSS as proposed.

First, the new design features are untested. Evidence on the positive effects of auto-enrolment has come from different employer environments, not nationally[6]. The feasibility of low charges is challenged[7], and there is no evidence to suggest individuals appreciate the benefits. The worldwide evidence on employer compulsion is mixed and controversial[8]. Although these features feel intuitively right to many people, others disagree, as indicated by the range of valid alternative models proposed.

Second, multiple new features in the NPSS set up significant implementation challenges. The project to get a host of new systems right all at once will be huge, and has not been costed.

The KiwiSaver approach of working from existing products and infrastructure offers an alternative approach for the UK: take one step at a time, and adapt as necessary. Evolution not revolution will reduce the risks of design mistakes and overspend.

How might such a flexible approach work in the UK?
Auto-enrolment seems to be the most widely accepted benefit of the NPSS proposals. A first step in a gradual implementation of the NPSS could therefore be to auto-enrol employees (perhaps on job changes) into existing approved vehicles (stakeholder or occupational plans).

Employers would be required to go one stage further than the current stakeholder requirements to ensure that employees are actually auto-enrolled. The policing of this would need to be improved[9]. Employers could choose a provider for their employees (for example their existing scheme). There could also be a small number of default providers chosen by a Government agency through competitive tender. Employees could select one of these or be allocated randomly if no selection is made. The competitive tender would be the driver for low charges, as well as for good service, investment governance and product design. Default funds could be provided by insurance or investment companies or large pension trusts.

After a period laid down in regulation (say, 5 years) the lessons of what works and what does not could be reviewed. Changes could be made depending on the actual outcome of such critical uncertainties as: the number of new savers, employer and employee contribution rates, the effect on wages, whether existing good pension provision has been levelled down or closed, running costs and product charges. For example, it might be appropriate to introduce compulsory employer contributions or tighten the criteria for default providers. A contribution clearing house could be needed, or the system could be working well enough without. Any such changes would be easier to identify and implement once the system has been running for some time.

This approach has clear benefits. As existing regulation could be used and less institutional change would be needed, it could start sooner than the full NPSS model, before 2010. It would be less risky. It does not require a massive bet that a single model will work. Instead the proposed model would be tested, outcomes measured and the approach gradually refined.

It may not reach the intended outcome as quickly as the NPSS proposals are intended to do. However, by starting with auto-enrolment, this approach does cover much of the 'new' thinking of NPSS. Given the risks in the prescriptive NPSS proposal, and its place in the policy priorities, it seems more sensible to approach it with some flexibility than to try to design the perfect system for day 1.

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[1] Pensions Commission (2005) *A New Pensions Settlement for the Twenty-First Century* p. 109 and p. 401
[2] Simplified from Pensions Commission (2005) p. 289 and p. 299
[3] Memo 6 April 2005 from Minister of Finance to Cabinet Policy Committee
[4] Pensions Commission (2005) p. 274
[5] Memo 6 April 2005 from Minister of Finance to Cabinet Policy Committee
[6] An alternative to auto-enrolment has been proposed by the academics who provided much of the research on the efficacy of auto-enrolment in US plans. See Choi et al (2006) *Reducing the Complexity Costs of 401(k) Participation Through Quick-Enrolment* Pension Research Council, The Wharton School, University of Pennsylvania
[7] See, for example, submissions on NPSS by ABI and NAPF (2006)
[8] See, for example submission on NPSS by CBI (2006) and PPI (2005) *Should earnings-related pensions be voluntary or compulsory?*
[9] Note that even this is not trivial. 20% of employers who currently should be offering a stakeholder pension are not (mostly small employers), and only one employer has been fined for not doing so. PQs Philip Hammond *Hansard* 24 Jan 2006 Column 2058W
[10] Based on Pensions Commission (2005), www.securingyourfuture.govt.nz and interviews. See a forthcoming PPI research paper for details.

Table 1[10]: Significant implementation differences between the Pensions Commission's NPSS proposal for the UK and the KiwiSaver proposal in New Zealand

	NPSS	KiwiSaver
Number of workers eligible	~23 million day 1	700,000 pa
Expected number of members	~7 million day 1 plus those switching from other provision	520,000 after 5 years
Contribution collection system	Need new system to compensate for annual PAYE	Can use existing monthly PAYE system
Overlap with existing provision	~45% of workers have some private pension coverage	<15% of workers have some private pension coverage
Approach to industry	Change cost base and nature of operation	Work with existing providers and products
Clearing house	New body acts as clearing house for individual accounts and communicates with members	Inland Revenue allocates individual contributions to providers who communicate directly with members
Governance	Need new body	Use existing product/provider regulation. Government runs a competitive tender for default providers.
Regulation	Need to police compulsion on employers to contribute and transfer information and employee contributions	Need to police compulsion on employers to transfer information and employee contributions
Information and advice	Not covered in Pensions Commission report	Existing *Sorted* website gives generic financial information. Government to run education campaign explaining KiwiSaver. Providers can give 'advice'.
Overall approach	**'Big bang' to new world**	**Gradual implementation using existing processes**

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