

PPI submission to DWP call for evidence *NEST: Evolving for the future*

About the Pensions Policy Institute

- 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.

Introduction

- II. The consultation seeks evidence in two specific areas as to whether:
 1. There is a case for expanding the opportunities for individuals, employers and other schemes to access NEST's proposition.
 2. NEST should develop and offer decumulation services for its members.

Alongside specific questions concerning the service offered by NEST, the consultation also asks *"Is there any other evidence or factors about how the pensions landscape is changing that we should take into account in considering NEST's future policy framework?"* This response provides such evidence from PPI research, split into two parts (A & B) dealing with the different areas of consultation.

- III. This response sets out key evidence from PPI research articulating what is known about the needs from the perspective of the individual and identifying where there may be gaps in provision and thus where the market may wish to develop.
- IV. The PPI does not make any policy recommendations in our response, rather we present the research findings as a starting point for the policy debate, highlighting potentially useful avenues of further research.

Executive summary

- Despite the success of automatic enrolment removing the earnings threshold would bring in more women, ethnic minorities, those with disabilities and carers. Accounting for all jobs, not just the first, would bring around 80,000 people into Automatic Enrolment by taking such people above the earnings threshold.
- Saving at the minimum contribution rate of 8% of band earnings may not be enough for some people to have an adequate income in retirement.
- A 'lower earner' will need a total contribution rate of 11% of band earnings to have a three-quarters chance of achieving their target replacement income; by contrast, a median earner will need to contribute 13% and a higher earner 14%.
- Escalating contributions provides an alternative to a step change to a higher, flat rate.
- Removing the band earnings, especially the lower one, would increase overall savings levels across the board, with the greatest impact on those with lower incomes.
- Defaults appeal as they preclude active decision-making, and have traditionally played a strong supporting role in pension saving and access.
- The retirement system is moving away from defaults, which has led to a 'default dichotomy'.
- Many people are poorly equipped to make the necessary complex decisions at retirement, due to factors such as inertia or poor cognitive ability.
- DC members seek support from the wider pensions industry with defaults and choices up to, into, and through retirement.
- The Government does not intend to put any new at-retirement defaults in place, but there is new support on offer for DC savers.
- One way in which the industry can support retirees is in the use and design of default strategies for retirement choices.

Part A: Access to NEST's proposition

Despite the success of automatic enrolment removing the earnings threshold would bring in more women, ethnic minorities, those with disabilities and carers. Accounting for all jobs, not just the first, would bring around 80,000 people into automatic enrolment by taking such people above the earnings threshold.

1. The Pensions Act 2008 provided for the introduction of automatic enrolment into workplace pension schemes. Automatic enrolment policy started rolling out in October 2012, with the largest employers enrolling eligible employees into qualifying workplace pension schemes, in which employees will remain unless they actively opt out.
2. At the end of June 2015, 20.2m workers had been assessed for eligibility. 9.3m of these workers were already active members of a qualifying pension scheme. 5.3m were automatically enrolled into a workplace pension scheme. 5.2m were found ineligible for automatic enrolment.¹
3. In order to be eligible for automatic enrolment an individual has to be employed, earning over £10,000 (the "Earnings Threshold") and aged between 22 and State Pension age. Just under a quarter (23%) of all employed people in the UK did not meet the qualifying criteria for automatic enrolment, though around a quarter (1.4m) of these people are currently saving in a workplace pension scheme independent of automatic enrolment, leaving around 4.8m employed people who are both ineligible and not saving in a pension scheme.
4. The main reason for not meeting the qualifying criteria is low earnings. 57% (3.5m people) of those not meeting the qualifying criteria earn below the £10,000 Earnings Threshold.² Those earning below the threshold are typically on part-time work or receive less than the minimum wage³ or may be in full-time education.
5. 43% of the ineligible population, (10% of the UK employed population) are ineligible through being under age 22 (29%) or over SPa (14%). PPI analysis⁴ shows that:
 - **Women are less likely to meet the qualifying criteria for automatic enrolment and more would qualify if second jobs were included in the assessment**
Of 13m employed women in the UK, around 4m (32%) do not meet the qualifying criteria for automatic enrolment, compared to 16% of male workers.

¹ The Pensions Regulator (2015) Automatic enrolment Declaration of compliance report, July 2012 – end May 2015

² ONS – Labour Force Survey data, March 2015

³ Working full time (40 hours per week) at the minimum wage, £6.50, would earn £13,520pa

⁴ PPI Briefing Note 75: *Who is ineligible for automatic enrolment?*, September 2015

Automatic enrolment qualification is assessed on a “per job” basis and women are more likely than men to work part-time (in 2011, 16% of employed men and 44% of employed women had part-time jobs⁵). If the income from both first and second jobs was taken into account when assessing eligibility for automatic enrolment, then a further 80,000 people (60,000 women and 20,000 men) would earn enough to meet the qualifying criteria.

- **People from some ethnic groups are more likely to be below the earnings threshold.**

91% of the Bangladeshi workers, 80% of Chinese workers, 78% of Indian workers, and 63% of Black/African/Caribbean workers who do not meet the qualifying criteria are earning below the £10,000 Earnings Threshold in their main job. This compares to 56% of ineligible white employed people.

Again, if second jobs were taken into account then a further 5% (6,000) of all Bangladeshi workers and a further 1% (3,000) of all Pakistani workers, would meet the qualifying criteria for automatic enrolment.

- **30% of disabled workers do not meet the qualifying criteria for automatic enrolment.**

Approximately one third (30%) of employed people with a disability, as defined under the Equalities Act, do not meet the qualifying criteria for automatic enrolment (c. 900,000 of the 2.1m employed people who have a disability, compared to 23% of disability-free employed people).

However, people with a disability are far less likely to work than those without. In 2012, 46% of people aged 22 to SPA with a disability were in employment compared to 75% of non-disabled people.

71% (649,000) of the employed people with a disability who do not meet the qualifying criteria are earning below the £10,000 earnings threshold.

- **The vast majority, 81%, of employed carers do not meet the qualifying criteria for automatic enrolment.**

Over three quarters, 81% of employed carers (in receipt of caring related benefits) do not meet the qualifying criteria for automatic enrolment. Many carers work part-time due to their caring responsibilities (between 2001 and 2007, 25% to 27% of all female carers and 5% to 15% of all male carers worked part-time)⁶.

96% (35,000) of the carers who do not meet the qualifying criteria earn below the £10,000 earnings threshold (not including those over or under qualifying age).

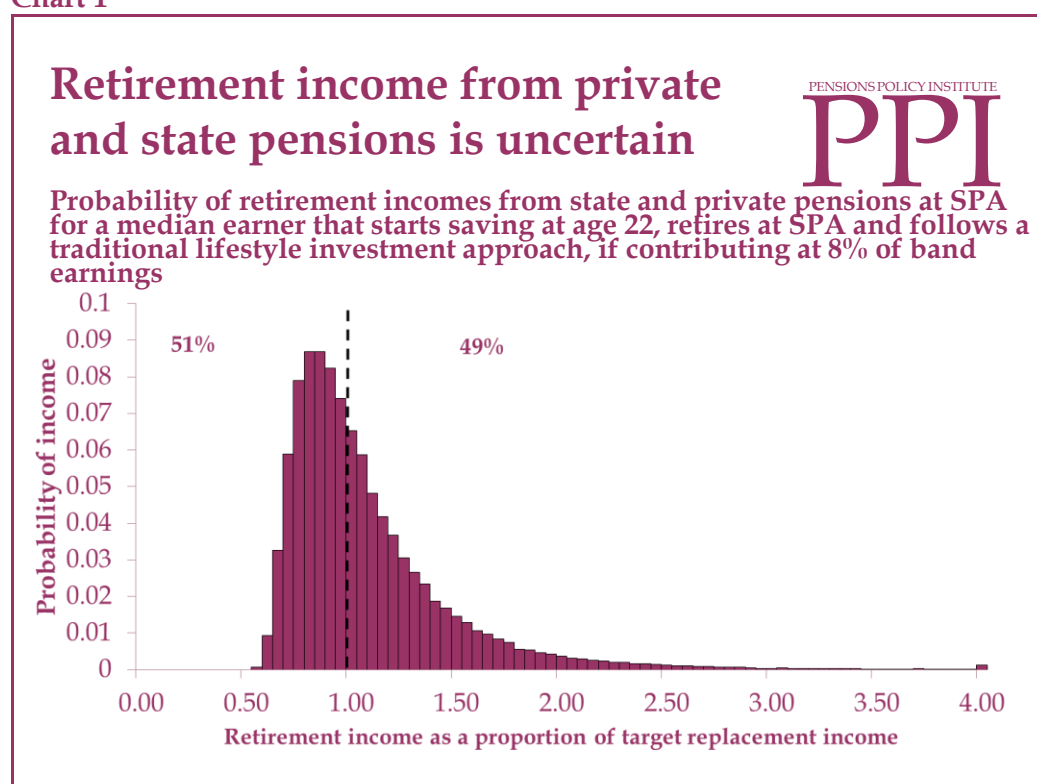
⁵ ONS (2011) Ethnicity and the Labour Market, 2011 Census, England and Wales

⁶ Carers UK, University of Leeds (2007) Managing Caring and Employment

Saving at the minimum contribution rate of 8% of band earnings may not be enough for some people to have an adequate income in retirement.

- The target replacement income for a median earner is 67% of their pre-retirement earnings. In 49% of the cases generated in the modelling a median earner could reach their target replacement income with private and state pensions income, if starting to save at age 22, retiring at State Pension age (SPA), following a traditional lifestyle investment approach and contributing at 8% of band earnings (Chart 1).⁷

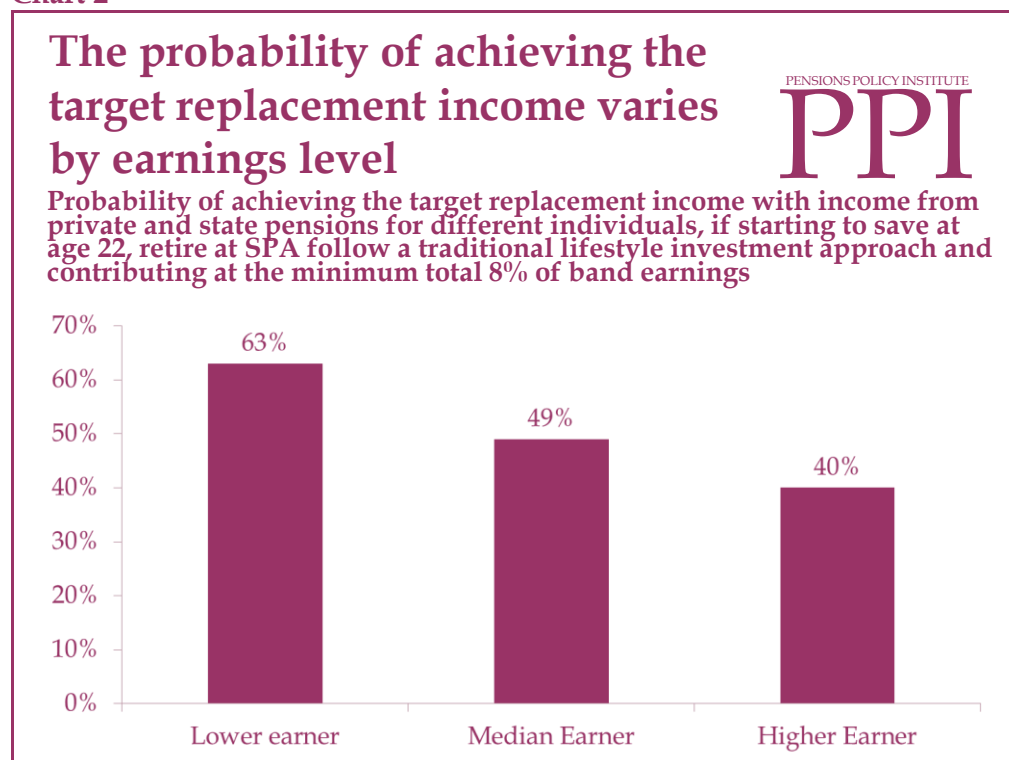
Chart 1



- Saving at the minimum contribution rate of 8% of band earnings, however, may not be enough for some people. In more than half of the scenarios modelled income is below the target replacement income and in 25% of the scenarios income from private and state pensions was less than 75% of the target replacement income.
- Lower earners have a higher probability of achieving their target replacement income than median or higher earners (Chart 2).⁸

^{7,8} PPI (2013) *What level of pension contribution is needed to obtain an adequate retirement income?*

Chart 2



A 'lower earner' will need a total contribution rate of 11% of band earnings to have a three-quarters chance of achieving their target replacement income; by contrast, a median earner will need to contribute 13% and a higher earner 14%.

9. The contribution rate needed to have a good chance of achieving the target replacement income will depend on different factors such as an individual's earnings level, the investment approach followed and the level of charges paid, the indexation mechanism used to uprate the single-tier pension and changes in contribution patterns.⁹
- Lower earners need lower contribution rates than median and higher earners to have a good chance of reaching their target replacement income, but this depends on the indexation mechanism used for the single-tier State Pension.
 - If the single-tier State Pension is uprated by the triple lock, a lower earner will need a total contribution rate of 11% of band earnings to have a three-quarters chance of achieving their target replacement income. By contrast, a median earner will need to contribute 13% of band earnings and a higher earner will need to contribute 14%. This compares to 15% for a lower earner and 17% for median and higher earners if the single-tier State Pension is uprated by changes in average earnings only.

⁹ PPI (2013) *What level of pension contribution is needed to obtain an adequate retirement income?*

Escalating contributions provides an alternative to a step change to a higher, flat rate.

10. The escalation of contribution rates can be achieved in practice through auto-escalation mechanisms. These introduce default contribution options linking the rate and timing of escalations to certain circumstances. The PPI have modelled escalation patterns increasing contribution rates based upon individual circumstances, specifically:¹⁰
 - **Age** - the contribution rate increases as the individual becomes older.
 - **Job tenure** - the longer an individual remains in a job the higher the contribution rate is set.
 - **Pay increase** - as an individual's pay increases a part of that increase is used to fund an increase in contribution level.
 - **Pay level** - the contribution rate is linked to the earnings of the individual. Earnings are compared to National Average Earnings (NAE) to set the contribution rate.
11. These scenarios link higher contribution rates to when an individual may be better able and willing to make an increased level of contribution, which should reduce the risk of opting out against a step change in contributions. Escalating contribution patterns are designed to increase the accumulated pot at retirement. The scenarios modelled increase the contribution level from the current level of 8% up to a maximum of 15%.
12. The impact of each scenario upon four people (Annex - Table A1) reflects the rate of increase in the contribution level and whether the higher level is maintained or not as in the case of linking contribution levels to job tenure.
13. Outcomes are broadly consistent across people for all escalating patterns, except in the case of the increase by pay level. In that scenario, contributions for those with higher incomes increase at a greater rate, thus having the greatest impact upon retirement outcomes (Annex - Table A2).
14. Escalation based on pay increases generally improves the relative size of the pension pot size for all the people modelled, with the low earning female being the most advantaged although the difference across the four people is marginal.

Removing the band earnings, especially the lower one, would increase overall savings levels across the board, with the greatest impact on those with lower incomes.

15. At present, there is a band of earnings on which auto enrolment minimum contributions are calculated; the first £5,824 pa does not count as does anything over £43,000 pa (2016 2017).

¹⁰ PPI (2015) *Automatic enrolment contribution scenarios post 2017*

16. For someone earning £10,000 pa (and therefore eligible for auto enrolment) £4,176 pa qualifies, or 3.4% of salary. This percentage increases for higher salaries towards the upper limit of £43,000 pa, and then starts to reduce due to the cap on contributions (Table 1).

Table 1: The effect of qualifying earnings on auto enrolment contributions based on an 8% total contribution

Annual salary	Qualifying earnings	% of salary	No lower limit - % of salary
£10,000	£4,176	3.4	8.0
£15,000	£9,176	4.9	8.0
£20,000	£14,176	5.7	8.0
£40,000	£34,176	6.9	8.0
£50,000	£36,561	5.9	6.9
£60,000	£36,561	5.0	5.7

17. The current band impacts part-time workers particularly, as qualifying earnings are required for each job that they hold.

Part B: Decumulation Services

Defaults appeal as they preclude active decision-making, and have traditionally played a strong supporting role in pension saving and access

18. As is becoming widely accepted within the field of behavioural economics, inertia - a reluctance to seek information, make decisions or take action, plays a key role in determining people's behaviour. Defaults appeal to people because they preclude having to make time-consuming or complex decisions. Even positive intention or belief in the worth of a particular course is often defeated by natural tendencies towards inertia, for example the vast majority of people in the USA support organ donation but only a quarter have registered because of the active decision involved.
19. The State Pension system is governed by defaults. People contribute automatically through the National Insurance system and receive a pension that inflates with prices from their State Pension age until death. There is an option to delay the receipt of a State Pension in return for a higher income, however the majority of people do not take this up.
20. Traditionally, the majority of private (non-state) pension schemes were also structured around defaults. Employer sponsored Defined Benefit (DB) schemes automatically subtract a contribution (if any) from employees in return for a pension, inflating with prices, paid from pensionable age until death.

21. Over the past few decades, private sector employers have increasingly offered Defined Contribution (DC) pensions rather than DB pensions, often through a third-party provider. Defaults have traditionally supported the DC system as employees are generally enrolled into their employer's choice of scheme, invested in the default fund while saving, and, until April 2015, those accessing their DC savings out were effectively defaulted into purchasing an annuity or a capped income drawdown product with their savings unless their savings were above or below certain levels.

The retirement system is moving away from defaults, which has led to a 'default dichotomy'.

22. From April 2015 people with DC savings over the minimum pension age (age 55) would not be required to purchase an annuity or a drawdown product in order to access their DC savings. Instead, they would be allowed to withdraw their DC savings in unlimited amounts, taxed at an individual's marginal rate (with 25% of the amount withdrawn tax-free).
23. The introduction of increased flexibility removed some at-retirement defaults from the system. Though people are still permitted to purchase an annuity and / or income drawdown product they are no longer obligated to do so.
24. Different options are associated with different risks:
 - People taking lump sums or using drawdown are more at risk of running out of savings during retirement due to long life, high withdrawals or poor investment performance.
 - People purchasing annuities generally forgo the opportunity to earn returns on their savings and may not be protected against inflation, unless they have purchased an annuity which increases by an inflationary index each year.
25. The result of the increased flexibility at retirement, is that most DC savers are faced with a dichotomous system:
 - During the accumulation phase, pension saving is governed by defaults as employees are automatically enrolled into the default fund in their employers' choice of scheme and, if they do not actively opt out, make at least minimum required contributions which are automatically deducted from their salary.
 - Once people decide to access their DC savings, however, there are no automatic defaults in place. From age 55 people can withdraw savings in any way they wish, though income tax applied to withdrawals may discourage some people from withdrawing in very high amounts.

Many people are poorly equipped to make the necessary complex decisions at retirement, due to factors such as inertia or poor cognitive ability.

26. Decisions people make at retirement are affected by both internal (behavioural and cognitive) factors and external (structural) factors. This encompasses a host of influences, with the most influential being:

The tendency towards inertia:

27. Many people display a natural tendency towards inertia, manifesting as a reluctance to seek information or make active decisions. Natural tendencies towards inertia are exacerbated by the complexity and uncertainty surrounding decisions about pensions and retirement.

28. A general lack of trust in the sustainability of the State Pension and in the providers of private pensions reinforces fears and uncertainty. Trust in employer-sponsored pensions is higher than it is for third-party run pensions.

29. Inertia can arise from:

- Competing priorities taking precedent;
- A lack of funds, making people feel that there is no point trying to make decisions; or
- Intimidation at the prospect of making decisions.

Cognitive abilities:

30. Levels of numeracy in particular have been found to have correlations with a person's ability to understand pension arrangements. In the UK levels of numeracy among adults are low. In 1999, around 20% of adults (around seven million) were found to have more or less severe problems with basic skills, in particular with what is generally called 'functional literacy' and 'functional numeracy'.

DC members seek support from the wider pensions industry with defaults and choices up to, into, and through retirement.

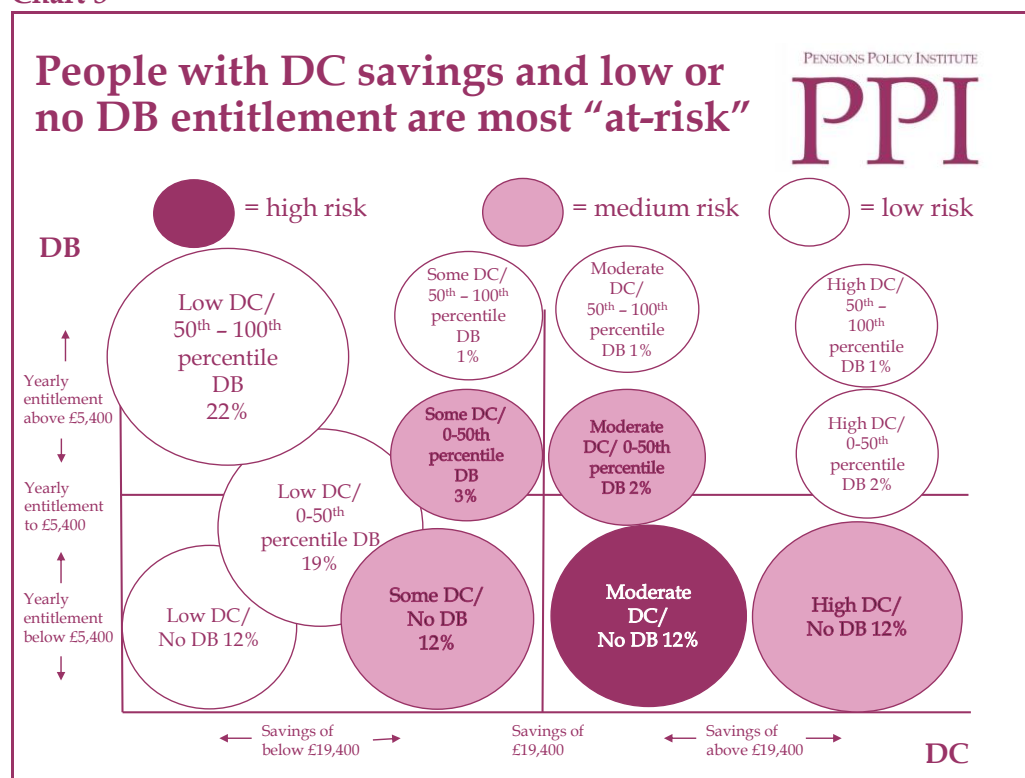
31. Decisions about accessing DC pensions are difficult as they often require understanding of complex and uncertain economic and market concepts such as inflation, investment risk and longevity risk. Since April 2015, greater levels of flexibility have complicated the decisions that DC savers make. Around 5.7 million people currently (2014) aged between 50 and SPa will have some private pension savings or entitlement at their SPa. Of the 5.7 million:

- Half of these people will have DC pots of £6,300 or less, including those who will have no DC savings. Around three quarters of this group will have DB entitlement.
- Half will have DC pots of £6,300 or more and around a quarter of these will have DB entitlement.

32. PPI modelling of ELSA¹¹ data indicates that (Chart 3):

- 12% of people currently aged 50-SPa in England (694,000 people) will be at “high-risk” of making poor decisions at SPa if they are not offered support through either guidance and advice or suitable defaults. These people will have between £19,400 and £51,300 in DC savings (and little or no additional DB pension to fall back on).
- A further 29% (or 1.6 million) people aged 50-SPa in 2014 will be at “medium risk” of making poor decisions. These are groups with anywhere from £6,300 to above £51,300 in DC savings and little or no additional DB.¹²

Chart 3¹³



33. This suggests that around 4 in 10 retirees may need significant support over the next ten to fifteen years because they will be dependent to a significant degree on the income from their DC savings in retirement to supplement their State Pension.

The Government does not intend to put any new at-retirement defaults in place, but there is new support on offer for DC savers

34. The Government has announced that it does not intend to legislate for a default option at any time in the near future. However, it is aware that DC savers are more vulnerable to making poor decisions in a more flexible

¹¹ English Longitudinal Study of Ageing, Wave 5

¹² PPI (2014) *How complex are the decisions that pension savers need to make at retirement?* PPI

¹³ PPI Dynamic Model

pensions market and has introduced some support in the form of a free, 45-minute guidance service offered to people with DC savings from age 50. Since inception in April 2015, DC savers have had 49,400 face-to-face and 23,200 telephone sessions through the Pension Wise service.¹⁴

35. There are other supports available to DC savers through paid financial advice or free guidance or information from organisations such as the Citizens Advice Bureau. People are also able to access guidance or information from the Pensions Advisory Service or the Money Advice Service.
36. However, there are still concerns that someone who requires advice and/or guidance might not access the service which they need or might not use any advice or information in order to make informed decisions about accessing DC savings.
37. Many of those reaching retirement in need of advice have not saved sufficient amounts to provide themselves with a standard of living in retirement which they will find acceptable. A lack of sufficient savings can make options at retirement even trickier to choose from as all options might lead to sub-optimal outcomes and the little savings people do have might be needed to support future needs in retirement (such as health care needs or house repairs) which won't necessarily be foreseeable.

One way in which the industry can support retirees is in the use and design of default strategies for retirement choices.

38. The following conclusions on default design are based on the outcomes from focus groups conducted on the behalf of the PPI:
 - **Having a default investment or drawdown option** that could be utilised at some point at or during retirement resonated with DC savers – though they recognise the importance of wider individual and household circumstances and the need for there to be choice for those who want it.
 - Given the existing lack of understanding around the underlying investments in default funds, and what the funds are seeking to achieve, it is be important that any **defaults and alternatives offered are clearly branded and communicated** in terms of objectives and risk-level.
 - DC savers are generally reluctant to make up-front commitments about the point in time at which they might be willing to lock their money in to a particular strategy. They are also reluctant to hand over significant sums of capital in the early years of retirement to another party.
 - While this reluctance may act as a barrier to the take up of some forms of annuities, concepts like longevity insurance and the payment of ongoing premiums resonated with the majority of those interviewed, and they were willing to make some sacrifices in income in early years to ensure they had a secure backstop should they live to longer ages.

¹⁴ www.gov.uk/performance/pension-wise

39. However while the design of defaults is important and can have an impact on outcomes, other factors such as the level of contributions paid into the pension fund and the length of time spent contributing are likely to have a greater impact.
40. Despite the Governments lack of appetite for defaults, support exists within the industry for decumulation strategies:
 - Age UK believes that it is important that the system "delivers for disengaged pension savers as well as for engaged ones, because we have auto-enrolled them into a scheme".
 - PLSA argues that default options should act as the first line of defence, backed up by the guidance service and the additional protection measures required of providers.
 - ABI pointed out that inertia and defaulting would not work in the same way as for accumulation: the wide range of decumulation options available meant that "some engagement with the process" from savers would be necessary.
41. It is not yet clear whether "defaults" will emerge from the market that is evolving following the new pension freedoms. With consumers remaining unsure of what they might need to support themselves in retirement and unaware of available options, and with challenges in providing guidance and advice to all individuals, it is not clear how strong demand will be for specific new products and whether products such as those suggested by NEST in its blueprint¹⁵ will evolve naturally. Without strong consumer demand, it is less likely that the industry will develop similar products, even though they may ultimately be in the interest of consumers.

¹⁵<https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/The-future-of-retirement.pdf.pdf>

Annex

Table A1: Summary of individuals modelled

Individual	Attributes	
	Earnings profile	Career profile
Median male	Median male	Continuous working
Low earning male	10 th percentile male	Continuous working
Median female	Median female	Career break for caring for children
Low earning female	10 th percentile female	Career break for caring for children

Table A2: Increase in projected automatic enrolment pot sizes for individuals against the current system.

Increase in automatic enrolment pension pot size (% above current system outcome)	Median male	Low earning male	Median female	Low earning female
Escalation by job tenure	51%	51%	46%	47%
Escalation by pay increase	85%	85%	84%	87%
Escalation by pay level	76%	0%	35%	0%
Key	≥ Current system ≤10% flat rate	>10% flat rate ≤12% flat rate	>12% flat rate ≤15% flat rate	>15% flat rate