PENSIONS POLICY INSTITUTE PPI

Will personal accounts increase pension saving?

Introduction

The Government has proposed three key reforms to private pensions policy:

- Auto enrolment into work-based pension schemes for eligible employees.
- The introduction of compulsory employer contributions for employees who remain opted in to work-based saving.
- The introduction of a new national pensions savings scheme, called personal accounts.

The Government has said that its reforms aim to increase the number of people saving for a pension and for personal accounts to complement, rather than compete with, existing good-quality pension provision.[1]

This Briefing Note summarises findings from a PPI research report funded by the Nuffield Foundation, *Will Personal Accounts increase pension saving?* The PPI has analysed the potential impact of the proposed reforms on pension saving in the UK. In particular, scenario analysis is used to project the number of new savers in work-based pension schemes if employees and other individuals respond in a variety of ways, and the level and split of total annual pension contributions and assets between existing types of provision and personal accounts.

These findings were presented at a PPI seminar held at the Nuffield Foundation in November 2007.

Table 1: The reforms are likely to increase the number of people saving

New savers in work-based pension schemes

	Optimistic (20% opt out)	Central (33% opt out)	Pessimistic (60-50% opt out)
Employees who are auto enrolled (and don't opt out)	7.1m	5.9m	3.6m – 4.5m
Self employed (could opt in)	**0.9m**	**0.75m**	**0.5m**
Others who could opt in	0.9m	0.6m	0.3m
New work-based pension savers (figures are rounded)	**9m**	**7m**	**4m-5m**

There is a lot of uncertainty about how employees and employers will respond to the reforms. This analysis seeks to inform debate about the range of possible outcomes that could occur rather than to present a forecast of the future.

The number of new work-based pension savers (Table 1)

The reforms are likely to increase the number of people saving in a work-based pension. However, levels of opt-out remain uncertain, since the UK would only be the second country to introduce a national system of auto enrolment. The reforms could result in at least 4-5 million new savers in work-based pension schemes and possibly up to 9 million. These people will not all be completely new to saving, since some of them will have previously been saving in a non work-based pension or in non-pension forms of saving, but many would benefit from the proposed employer contribution.

Higher participation in pension saving may mean that people are more likely to have an adequate income when they come to retire. However, there are also concerns that pension saving might not be suitable for everybody who is auto enrolled.[2] This might be because the individual is likely to receive a low return on their saving or because the pension contributions are unaffordable or the individual has significant amounts of personal debt. These concerns mean that very high levels of participation may not necessarily be the best outcome for the reforms.

Annual pension contributions

What could happen without reform?

A baseline scenario shows annual total pension contributions could fall from around £40 billion in 2006 to around £30 billion by 2050, relative to national average earnings if there is no reform (Chart 1). The main drivers of this decline are the assump-

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tions that two thirds of Defined Benefit (DB) schemes will close by 2035 and that employers will open less generous Defined Contribution (DC) schemes in their place.

What could happen with reform?
The Government's proposed reforms will have cost implications for most employers. This is because of the higher levels of participation in pension schemes that is likely to result from the requirements on employers to automatically enrol their employees into pension saving and to contribute at least 3% for employees who remain opted in.

When the reforms are introduced, employers may be able to pass on the extra costs in a variety of ways, for example, to consumers through higher prices, to workers through lower wage increases, or to shareholders or owners through lower profits. Currently, only around 15% of private sector employers offer schemes that are more generous than the 3% minimum contribution. These employers could decide to reduce their average contributions as a way of meeting the cost of the reforms. This is commonly referred to as 'levelling down'. The overall impact of the reforms on private saving – whether positive or negative - will depend crucially on how employers react when the reforms are introduced.

There is a lot of uncertainty about how employers will respond
The analysis that informs this briefing note uses four stylised scenarios to explore the possible implications if employers respond to the reforms in different ways.[3] Evidence about likely employer responses is limited, so the scenarios seek to illustrate the potential impact of a range of responses rather than imply that any of the scenarios is more likely to occur.

If employers *auto-enrol their eligible employees into existing pensions on existing terms*, the reforms could increase annual total pension contributions (made by individuals, employers and the state combined) by around £10 billion in 2012[4] compared to without reform, and by around the same amount into the future. This scenario assumes that employers already contributing greater than 3% into an existing pension auto-enrol non-members on existing terms. Those not currently offering a 3% contribution auto-enrol at the minimum 3% level either into a personal account or into an existing scheme (Chart 1: *existing terms*).

Chart 1: There is a lot of uncertainty about how employers will respond

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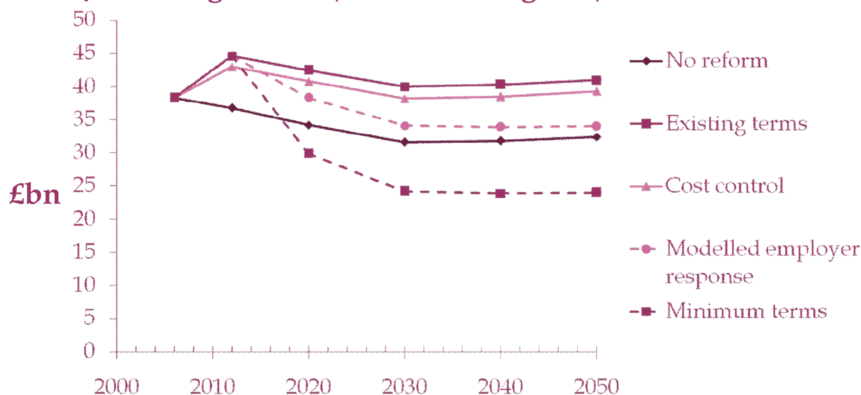
Annual total pension contributions, in £ billion, in 2006/7 earnings terms (unrounded figures)



If employers reduce their average pension contributions to *hold their pension costs constant*, the reforms could still increase annual total pension contributions by around £5 billion in 2012 compared to without reform, and by around the same amount in the future. This scenario assumes that employers who already contribute more than 3% have a fixed pension budget that they will spread across a larger group of scheme members after the introduction of auto-enrolment. Employers with less generous schemes, and those not currently contributing, are assumed to contribute the 3% minimum level into personal accounts (Chart 1: *cost control*).

If employers *act in line with a survey of their reported likely responses*, the reforms could initially increase annual total pension contributions by around £10 billion compared to without reform. By 2050 the reforms could still increase annual total pension contributions but by less than £2.5

billion. This scenario is informed by employer responses to a survey of 750 private sector employers that was conducted by Deloitte in May 2006.[5] In this scenario some employers auto-enrol on existing terms, some close existing schemes to new members and some switch to personal accounts (Chart 1: *modelled employer response*).

If all employers *auto-enrol new members on minimum terms* the minimum employer contribution level of 3% will become the norm over time. In this extreme situation, annual total pension contributions could be higher than without reform initially, as auto-enrolment takes effect, but by 2050 could be £10 billion lower (Chart 1: *minimum terms*).

Although annual total pension contributions could be higher than without reform under most of the scenarios, there would also be around 7 million more savers in work-based pension schemes. This means that average contributions for each saver could be lower than they would have been without reform.

Surveys of likely employer responses have been conducted but they cannot predict with certainty how employers will act five years in advance of the reforms being introduced. Given the significant impact that employer behaviour will have on the outcome of the reforms, it will be important to continue to build the evidence base on likely employer responses in the period leading up to the introduction of the reforms.

Chart 2: The reforms could change the shape of the pensions market

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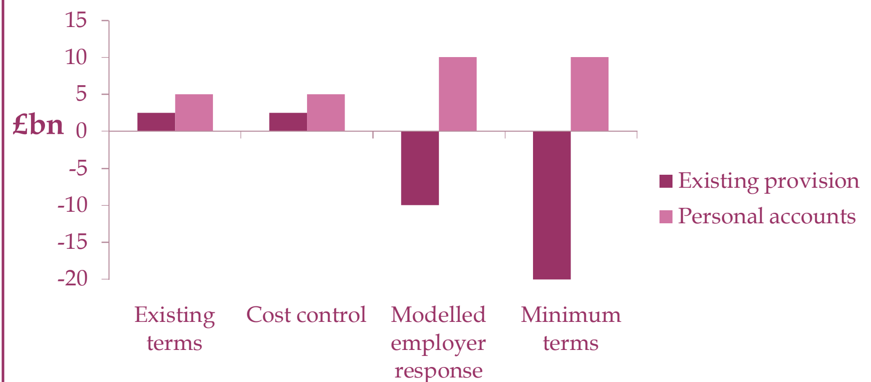
Change in annual pension contributions to existing provision and contributions into personal accounts in 2050, in £ billion, in 2006/7 earnings terms (rounded figures)



Split of annual contributions

Employers will have a choice about whether to auto enrol their employees into an existing pension scheme or into the new personal accounts. Their decisions will affect the shape of the pensions market in terms of the flow of annual contributions and size of assets in existing types of work-based pension provision and personal accounts (Chart 2).

If employers decide to auto enrol their employees into existing schemes on *existing terms*, or to *control their costs*, then the reforms could increase annual pension contributions to existing provision by less than £2.5 billion in 2050. This could benefit the current pensions industry. However, the bulk of the new contributions could be made from employers who do not currently offer a work-based pension scheme, and their employees. If these employers decide to use personal accounts, then total annual pension contributions into personal accounts could be around £5 billion a year by 2050.

In the *modelled employer response* scenario, some employers maintain existing schemes and keep them open to new members, while others switch to personal accounts. If this happens, then by 2050 annual pension contributions to existing provision could be £10 billion less than without reform and contributions into personal accounts could reach £10 billion a year.

If employers close their existing schemes to new members and enrol employees to personal accounts on *minimum terms*, then annual pension contributions into existing types of pension provision may be as much as £20 billion lower by 2050 than without reform. In this scenario annual contributions to personal accounts could be around £10 billion a year by 2050, which could mean a reduction in the total size of the pensions market.

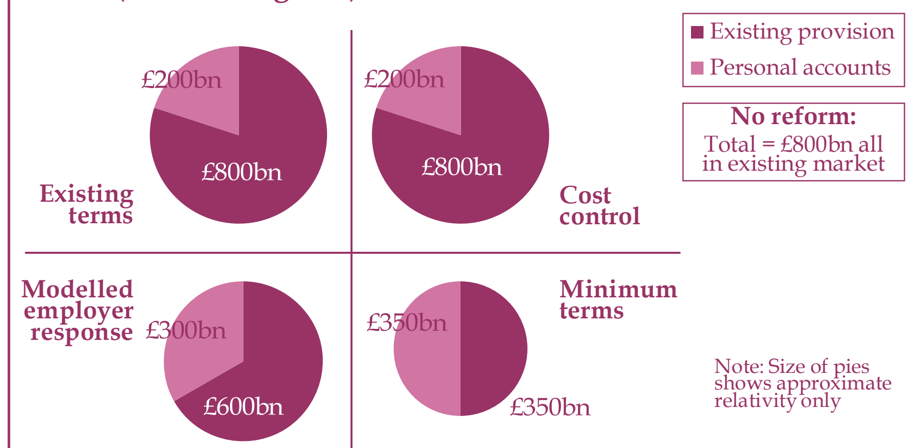


Chart 3: Funds in personal accounts could reach significant levels by 2050

Split of assets under management (Chart 3)

The aggregate size of pension funds under management is important because many personal pension providers levy charges on individual members using an Annual Management Charge (AMC), which is expressed as a percentage of assets under management. For these providers, the total amount of revenue collected from charges will depend on the aggregate size of the pension fund.

In the absence of reform, the aggregate size of pension funds is projected to reduce 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 personal accounts would not exist.

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

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 personal accounts could increase to around £200 billion, representing around one-fifth of the total pensions funds under management (Chart 3). In the *modelled employer response* scenario, personal accounts could grow to be one-third of the total assets by 2050. And, if employers auto-enrol on *minimum terms*, the proportion of pension assets that are held in personal accounts could be a lot greater, representing as much as half of the total funds under management by 2050.

Organisations in the private sector will be contracted to manage funds in personal accounts as well as to administer them. This means that any growth in the overall size of pension funds under management that results from the reforms could provide a range of opportunities for the private sector.

Conclusions

The interaction of pension saving with eligibility for means-tested benefits and the risk of employers 'levelling-down' their pension contributions both pose real challenges to the success of the reforms. This analysis shows that a range of outcomes is possible and that individuals' and employers' responses will be crucial in determining whether the reforms deliver both more people saving and more saving and better retirement incomes. Given the range of outcomes that is possible, it will be important to collect further evidence on the likely responses of individuals and employers, and for this evidence to inform the final policy and detailed design of the reforms.

[1] DWP (2006 PA) *Personal Accounts: a new way to save* (p 13) and the accompanying *Regulatory Impact Assessment* (p 3)
[2] See PPI (2006) *Are Personal Accounts suitable for all?* for more on this issue.
[3] See PPI (2007) *Will Personal Accounts increase pensions saving?* for the detailed modelling assumptions behind each scenario
[4] All of the scenarios are based on an overnight introduction of the reforms in 2012. In reality, the employer contribution will be phased in at a rate of 1% each year over 3 years.
[5] Deloitte (2006) *Employer pension contributions and pension reform: ABI research paper 2*

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