The Nuffield Foundation

PENSIONS POLICY INSTITUTE

PPI

Will Personal Accounts increase pension saving?

Executive summary

Summary of conclusions

The Government is introducing legislation that will mean that most employees will be auto enrolled into a work-based pension scheme from 2012 with an option to opt out. Employers will have the choice of auto enrolling their employees into an existing pension scheme or into a new national system of Personal Accounts. Under the proposals, employees who remain opted in to saving would contribute at least 4% of a band of earnings to the scheme. Employers will be required, for the first time, to contribute at least 3% of band earnings for employees who remain opted in. The Government will also contribute at least 1% through tax relief.

The principle of auto enrolment has been broadly supported as a way of overcoming inertia and increasing the number of people who save for their retirement. However, two concerns have been expressed. The first is that pension saving may not be suitable for all of the employees who are auto enrolled. The second, which is explored in this paper, is that employers might reduce or 'level down' their pension contributions in response to the increased costs they may face from the reforms.

The number of people saving for a pension

The reforms are likely to increase the number of people saving in a 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 new savers, 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 compulsory 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. 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 may mean that very high levels of participation may not necessarily be the best outcome for the reforms.

Annual total pension contributions

The future level of annual pension contributions is uncertain even without the Government's reform. Defined Benefit pension provision has already been declining in the private sector but there is not a consensus view among pension experts about the future of this type of provision. Contributions into Defined Contribution schemes, although growing, are also uncertain.

To analyse the possible outcomes of the reforms on annual pension contributions, this paper uses a baseline scenario for what could happen without reform. This shows annual total pension contributions falling from around £40 billion in 2006 to around £30 billion by 2050, relative to national average earnings.

The reforms will increase the costs of pension provision for most employers. This is because of the higher levels of participation in pension schemes that is likely to result from the requirement on employers to automatically enrol their employees into pension saving and because of the requirement to contribute at least 3% for employees who remain opted in. Currently, only around 15% of private sector employers offer schemes that are more generous than the 3% minimum contribution.

Employers may be able to pass on increased 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. However, employers who already contribute more than 3% of band earnings could decide to reduce their contributions as a way of meeting the cost of the reforms.

This paper uses four stylised scenarios to explore the possible implications of employers responding in different ways. Evidence on likely employer responses is limited, so the scenarios seek to illustrate the potential impact of a range of scenarios, rather than imply that any of the scenarios is more likely to occur. All of the scenarios are based on an overnight introduction of the reforms in 2012. In reality the Government intends to phase in the compulsory employer contribution over a three-year period at the rate of 1% each year.

The reforms could increase annual total pension contributions, although employer responses will be very important in determining the total impact of the reforms on pension saving:

- **If no employer decides to pass on the costs of the reforms by reducing their pension contributions, the reforms could increase annual total pension contributions (made by individuals, employers and the state combined) by around £10 billion in 2012 compared to without reform.**
- **Even if all of the employers who can reduce their pension contributions to hold their pension costs constant do so, the reforms could still increase annual total pension contributions by around £5 billion in 2012 compared to without reform. This is because employers who do not already offer the minimum 3% contribution to employees in work-based schemes will be compelled to do so under the reforms.**
- **If employers act in line with a survey of their likely responses, the reforms could increase annual total pension contributions by around £10 billion in 2012 compared to without reform. However, some employers have said they will close their existing schemes or reduce**

their pension contributions as a result of the reforms. The reforms could still increase annual total pension contributions in 2050 but by less than £2.5 billion compared to without reform.
- It is important that employers continue to offer more than the 3% minimum contribution. In the extreme situation where no employer offers more than the minimum, annual total pension contributions could be £10 billion lower in 2050 than without reform.

Although annual total pension contributions would be higher than without reform under most of the scenarios, there would also be around 7 million more savers in work-based pension schemes.

Although surveys of likely employer responses have been conducted, 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 employer responses in the period leading up to the introduction of the reforms.

The shape of the pensions market

Employers will have the choice of auto enrolling their employees into an existing pension scheme or into a new national system of Personal Accounts. Their decisions will affect the shape of the pensions market and the split of the market between existing types of work-based pension provision and the new Personal Accounts.

If employers decide to auto enrol their employees into existing schemes on existing terms, then the reforms could increase annual pension contributions to existing provision. 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 the majority of the increase in annual total pension contributions as a result of the reforms could be to Personal Accounts rather than to existing types of pension provision.

If employers choose to close their existing schemes as a result of the increased costs that they face from the reforms, then annual pension contributions into existing types of pension provision may be lower than without reform. This could lead to a reduction in the size of the existing pensions market compared to without the reforms.

It will be important for the success of the reforms that employers offer more than the 3% minimum contribution. If employers only offered the 3% minimum, then the aggregate size of pension funds under management in existing types of pension provision might still grow over time, but may not keep pace with growth in national average earnings.

The aggregate size of pension funds in Personal Accounts could grow to reach significant levels by 2050. Organisations in the private sector will be used to manage these funds as well as administer them. This means that the reforms could provide a range of opportunities for the private sector.

Policy implications and design choices

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. There is the potential for the reforms to achieve both of these objectives. However, there can be tensions between the two objectives. Some policy options may contribute positively to both but most involve a trade-off between the two.

The analysis shows that employers' responses to the introduction of the reforms will be critical in determining the overall impact that the reforms have on the level of pension saving.