What should qualify as earnings for auto-enrolment?

Introduction

There has been much discussion as to the appropriate definition of earnings that should be used as the basis of auto-enrolment into work-place pension schemes in the 2008 Pensions Bill. While the Government, using the recommendation made by the Pensions Commission, has put forward legislation to base the minimum auto-enrolled employee and employer contributions on all earnings (including bonus and overtime payments) between £5,035 and £33,540 (in 2006 earnings terms), other stakeholders have suggested that minimum contributions should be based on any basic earnings (excluding bonus and overtime payments) but from the first £1 earned.

This Briefing Note looks at the rationales, advantages and disadvantages of this and other proposed alternatives, including the recent proposals the Government have put forward in amendments to the 2008 Pensions Bill.

Why is an earnings definition necessary?

Defining the earnings to be used for auto-enrolment is an important part of setting out the minimum contribution level that will be required to comply with the new legislation.

When auto-enrolment and a compulsory employer's contribution were announced as part of the reforms, employers were concerned that the rate of employers contribution could be increased over time. So the Government agreed that the minimum contribution should be included in primary legislation, so that it could not be increased in future without further primary legislation.

However, there are three components to the minimum contribution:

- The employer contribution rate: (3%)
- The band of earnings on which the contribution is payable (£5,035—£33,540)
- The definition of what counts as earnings.

The Government's approach

The employer contribution level, the band of earnings on which contributions are made, and what counts as earnings that the Government has proposed in the current Pensions Bill are based on the recommendation made by the Pensions Commission[1].

The Commission recommendation was based on a calculation of how much someone working for 40 years on median earnings would need to contribute so that, when added to the amount that they could receive in state pensions, the median earner would have a combined state and private pension worth around 45% of their total earnings. This, in the Commission's view, would provide the base on which further private saving could be used to reach an acceptable level of retirement income.

So the 8% contribution level (comprising 4% individual, 3% employer and 1% Government contribution through tax relief) has been set to meet this target using a specific definition of earnings.

Chart 1: Most eligible members of DC schemes get more than the minimum contributions proposed by Government and the alternative proposals

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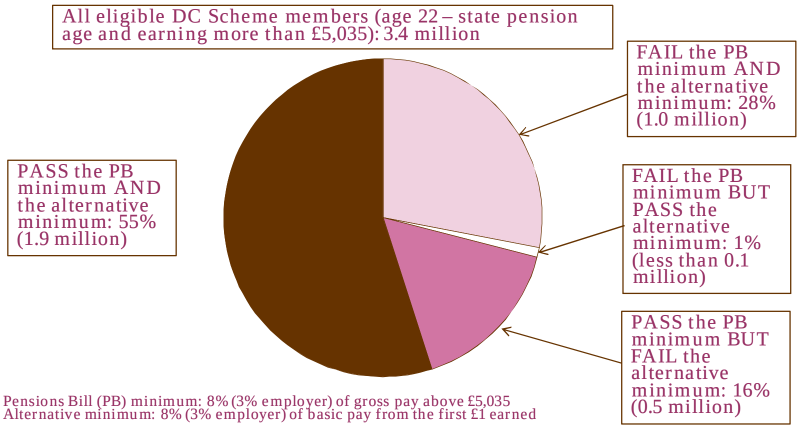
Members of existing DC schemes by whether or not their contributions meet the Pensions Bill (PB) minimum or the proposed alternative minimum



Pensions Bill (PB) minimum: 8% (3% employer) of gross pay above £5,035
Alternative minimum: 8% (3% employer) of basic pay from the first £1 earned

An important part of this calculation is that the target replacement income level in the calculation is set for both state and private pension. The state pension makes up a larger proportion of pension income for people with lower lifetime earnings than higher earners.

The minimum contribution calculation is therefore based on gross earnings, so ensuring that all pay is rewarded. By using an earnings band, this definition also ensures that those with the lowest earnings make relatively smaller contributions.

There are concerns with the Government's approach

However, a potential problem with this approach is that both the definition of what counts as earnings, and the band of these earnings on which contributions are payable, is different from those commonly used in private pension provision today.

Nearly 60% of current Defined Contribution (DC) occupational pension schemes use basic earnings[2] (that is without overtime and bonus payments) as the basis for pension contributions. And pension contributions tend to be made on any basic earnings from the first £1 earned, not just earnings in a certain band. For example, nearly all schemes in the 2008 NAPF annual survey of DC occupational pension schemes make contributions on all basic pay above zero.

In theory this is not necessarily a problem, as legislation does not require a single definition of earnings or pay band to be used in employer schemes, just that the amounts paid by the scheme must be equivalent to the minimum or higher.

But in practice, it may be difficult for employers to prove that their existing pension schemes pays the minimum contribution in all cases.

56% of members of DC schemes have total contributions of 8%, including employer contributions of 3%, of the definition of pensionable salary used by the scheme. The DWP estimates that, of these 56% of members, the vast majority (98%) will meet its proposed test (Chart 1)[3]. But in the remaining 2% cases (fewer than 100,000)—where for example overtime or bonuses make up a larger part of pay in any particular year—some individuals may receive less than the minimum required.

For many of the 2% of scheme members with lower then the minimum contribution, the shortfall may be relatively small, with average losses of around £300 a year[4]. However, a median earning individual who has half of his total pay made up of commission could lose £600 a year[5].

Reconciliation could be expensive

Despite the fact that official estimates suggest that relatively few individuals will end up with a lower contribution than the proposed minimum, the intention is that every individual will have to have their contribution checked to ensure that they have received at least the proposed minimum contribution.

The Government has recently laid amendments to propose that this only has to happen on an annual basis, rather than for every 'pay period' (e.g. week or month) as was originally suggested[4].

However, the need for employers to check actual contributions made against the minimum required for each individual, will add to the administrative costs of schemes. Some estimates suggest that the cost of reconciliation could be in the region of £150 per member[6].

Additional contributions would be required

On top of the extra administrative cost for employers, if individuals were found to have received contributions lower than the minimum, contributions would need to be topped up.

This would not just mean additional costs to the employer, but also to the individual (who would have to increase their own contribution) and the Government.

Extra cost could lead to opting-out and levelling down

Additional costs to both employers and individuals are likely to affect behaviour.

For the individual, there will be a trade-off—the higher contributions received from the employer and the Government during the reconciliation period are likely to be welcomed, but there is a danger that in some cases the additional individual contribution may be difficult to afford, as it could be required some time after the initial bonus or overtime payments were received, and when income is lower.

In some extreme cases the affordability issues could lead to individuals opting out of their work-place pension scheme. However, given the relatively small number of people estimated to be affected this should not affect overall opt-out rates significantly.

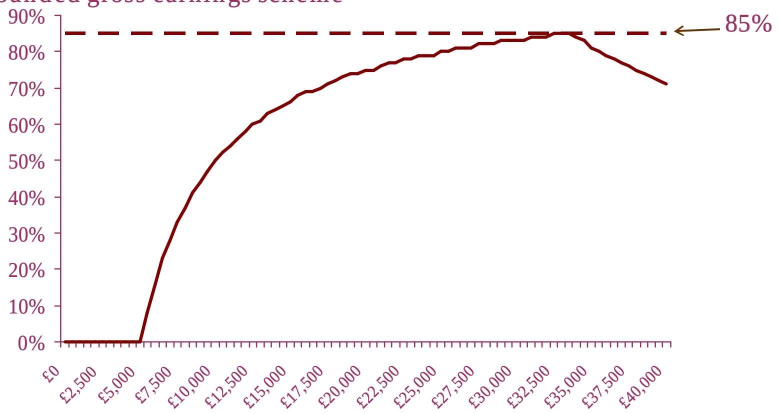
For employers, the impact may be greater. As with the individual, the higher cost of additional contributions may not be great for any particular employer, unless a large proportion of employees receive very low contributions.

But the greater administrative cost may affect what are already difficult decisions concerning the type of provision that is offered to employees. While it is still too early to tell how many employers will change their pension offering in the light of auto-enrolment, it is possible that additional administrative costs may further encourage changes in provision.

If this results in existing good schemes adopting a banded gross earnings definition, it would increase contributions to the minimum level for the 2% of members currently below the minimum. But it could result in lower contributions for many of the 98% of members who already receive the minimum contribution or more.

Chart 2: Contributions are higher in existing schemes if basic pay makes up at least 85% of total pay

Basic pay as a % of total pay needed for an 8% basic pay from the first £1 earned scheme to be at least as good as the proposed minimum from a banded gross earnings scheme



Levelling down may also have an impact on individual opt-out rates. If individuals are auto-enrolled into less generous schemes, they may be more likely to opt out.

What are the alternatives?

The proposed legislation would allow for schemes to continue to use existing scheme definitions, but to check the resulting contributions against the official minimum. One alternative would be to allow for an alternative definition of the minimum contribution.

The minimum could, for example, be judged by a rule of thumb, based on the relationship between basic pay and total pay.

As explained earlier, the proposed calculation of the minimum contribution is different in two respects from the definitions used in most existing schemes: the definition of earnings used in existing schemes is less generous, by including only basic pay; but the band of earnings on which contributions are paid is more generous in existing schemes, paying from the first £1 earned.

These differences work in opposite directions. Which definition is more generous for any individual depends on the amount of earnings, and how much of earnings is made up of basic pay. This relationship is illustrated in Chart 2, which shows for different levels of total earnings what proportion of earnings has to come from basic pay for a scheme paying 8% on basic pay from the first £1 earned to be more generous than the banded gross earnings scheme.

Chart 2 shows that those with higher earnings are most likely to have lower contributions in an 8% of basic pay from the first £1 earned scheme. For these individuals a higher proportion of total gross pay needs to be basic pay to be better off under an 8% of basic pay from the first £1 earned definition. Lower earners, a key target group for auto-enrolment, are more likely to do well from existing schemes.

Chart 2 also shows that if basic pay makes up at least 85% of total pay then every individual is better off in the basic pay from the first £1 earned scheme. As a result, if basic pay is at least 85% of total gross earnings no further calculation or reconciliation would be necessary. This useful 'rule of thumb' is permissible under the current draft legislation as a way of checking that minimum contributions have been paid.

A rule of thumb of 80% has also been proposed[7], to further reduce the number of individuals for whom detailed calculations would be necessary. This would mean that more schemes would qualify, but in some cases the minimum contribution received would be lower than the current minimum definition.

A scheme-based test?

A further proposal is that the minimum contribution level could be combined with a scheme test rather than an individual test, so that a scheme could be exempted if the majority—say 90% - of members get contributions above the minimum level[8]. As long as fewer than 10% of scheme members receive less than minimum contributions there would be no reconciliation exercise.

Some of the individuals who get less than the minimum in one year may get more than the minimum in other years if the scheme continue to pay 8% on all basic pay, depending on the pattern of their bonus and overtime payments.

A scheme test would mean that schemes would find it easier to be exempted, and that confirming that they are exempt would be easier and cheaper. However, it would also mean that, although the vast majority of members would get contributions of the minimum level or higher, a minority may get a contribution lower than the minimum level.

A recent Government amendment to the Pensions Bill 2008[9] has introduced a scheme-based test to the Bill. This would allow regulations to be laid later in the legislative process that set out the qualification criteria needed for a scheme to be able to certify that it is of sufficient quality for auto-enrolment.

However, the draft amendment still suggests that the test, will be related to "the jobholders of the employer who are active members of the scheme"[10], so it is not yet clear if this means that every individuals would need to receive at least the minimum contribution. An opposition amendment has been laid to remove this reference[11].

There is a trade-off to be made

The final decision will therefore be a trade-off:

- A lower burden on employers, with a small minority of individuals (less than 100,000) receiving less than the minimum but the majority of individuals receiving the minimum or higher
- Ensuring that every individual receives at least the minimum level of contribution, but with a higher administrative burdens potentially leading employers to make schemes less valuable to all individuals.

The largest impact on employers is not likely to be the additional contributions needed to meet the minimum for all individuals, but the additional administrative costs. And while for most individuals the losses might be relatively small, and could be more than compensated for in other years, those with a higher percentage of variable pay may face larger shortfalls in contributions.

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1 Pensions Commission (2005) ***A New Pension Settlement for the Twenty-First Century***
2 National Association of Pension Funds (NAPF) (2008) ***NAPF Annual Survey***
3 Department for Work and Pensions (DWP) analysis of Annual Survey of Hours and Earnings (ASHE) 2007 data set of people aged over 22 and under state pension age, and earning more than £5,035 a year
4 DWP analysis of ASHE 2007 data set
5 PPI calculation
6 ICAEW estimate
7 By ABI, NAPF, CBI and ICAEW
8 By ABI, NAPF, CBI and ICAEW
9 Amendment to be moved on Third Reading, Lord McKenzie of Luton, www.publications.parliament.uk/pa/ld200708/ldbills/089/amend/am089-b.htm
10 Subsection (2) of the amendment, and also subsections (6(e) and (f))
11 Amendment to be moved on Third Reading, Lord Skelmersdale, Baroness Noakes