



## Chapter 1: Individuals and automatic enrolment



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Automatic enrolment is one of the most effective ways of combating people's tendency not to act when faced with difficult financial decisions. It is central to tackling the problem of undersaving.

Recent analysis suggests that approximately 7 million people are not saving enough to give them retirement incomes they are likely to consider adequate.<sup>1</sup> Personal accounts will extend the benefits of private pension saving to those on moderate to low incomes who do not have access to a good employer pension scheme. The target group will include many younger employees and people who work for small firms.

In future, individuals will be automatically enrolled into exempt work-based pension schemes or personal accounts if they are employees aged between 22 and State Pension age, and earning above approximately £5,000 a year.

Contributions will be made on a band of earnings between around £5,000 and £33,500 a year, the personal accounts earnings band<sup>2</sup> (PAEB), which will be increased in line with earnings.

These reforms will provide good incentives to save. The combination of the employer contribution, tax relief and lower costs, combined with a reformed state pension system, will mean that saving will be worthwhile for the large majority of the personal accounts target group.

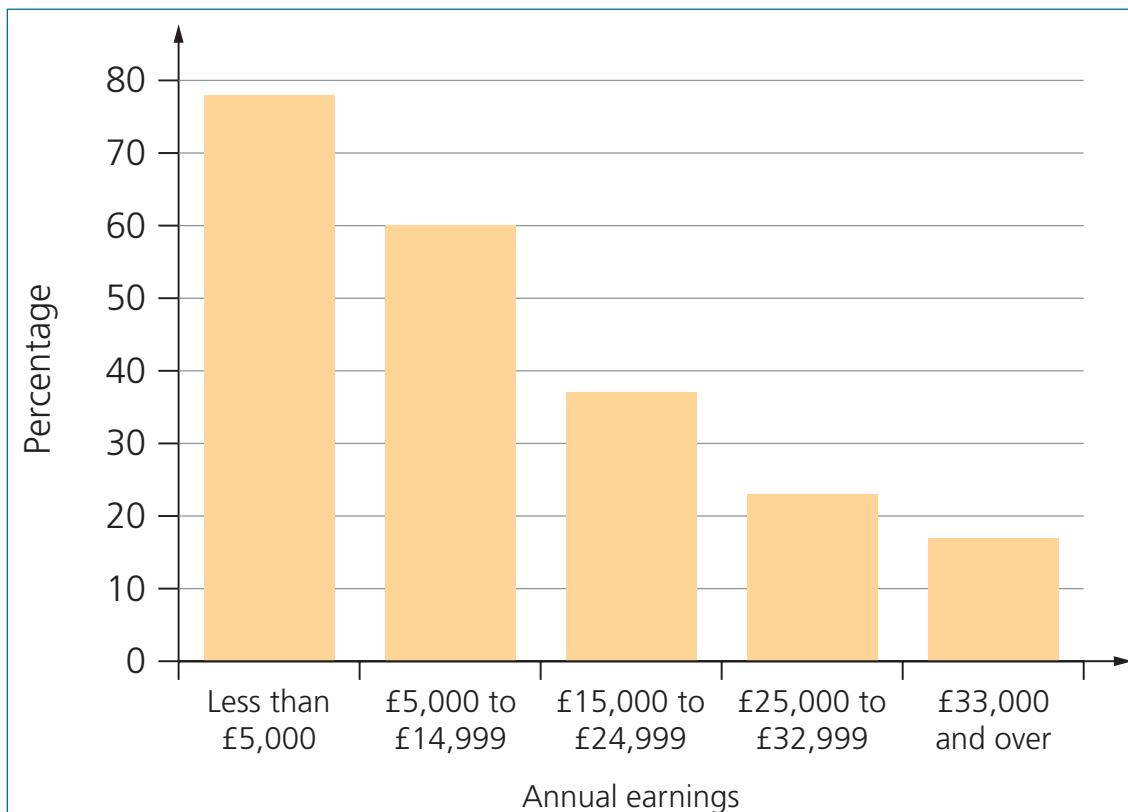
<sup>1</sup> Estimates of the current level of undersaving for retirement are difficult to construct due to: difficulties identifying appropriate saving targets; uncertainties about which kinds of wealth and asset to take into account; difficulties projecting individuals' future saving and working patterns, particularly around choice of retirement age; reliance on inadequate data; and reliance on a range of other uncertain assumptions, including the impact of future macro-economic developments. Consequently, such estimates should be treated cautiously. The current Department for Work and Pensions (DWP) estimate draws on analysis by the Institute for Fiscal Studies (Banks J, Emmerson C, Oldfield Z and Tetlow G, 2005, *Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England*, IFS). The May 2006 White Paper (*Security in retirement: towards a new pensions system*) sets out some of these issues in more detail.

<sup>2</sup> Employee and employer contributions will be calculated on earnings that fall within the PAEB. When launched, the limits for the PAEB will be aligned with the Primary Threshold and Upper Earnings Limit for National Insurance contributions at the time (£5,035 and £33,540 a year, respectively, in 2006/07).

## The target group

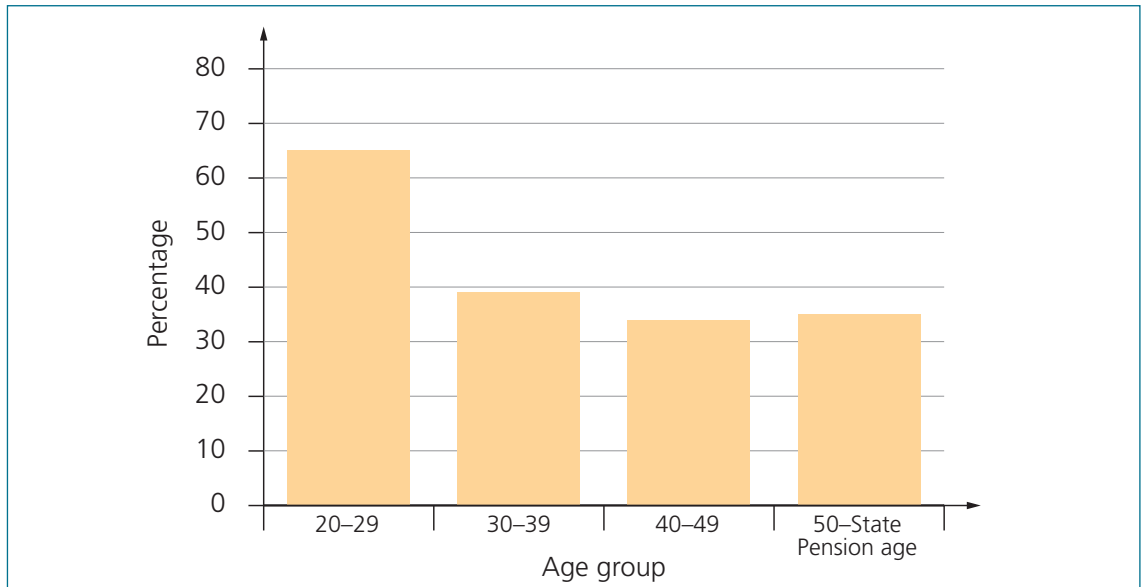
- 1.1 Personal accounts are particularly targeted at the estimated 7 million people who may not be currently saving enough to give them an income in retirement they are likely to consider adequate. We know that this group tends to be younger and on moderate to low incomes. They are also likely to be part-time workers and/or work for small employers. A high proportion of lower earners are women who are not likely to be saving in work-based pension schemes.
- 1.2 We have analysed the various groups where participation in private pension saving is lowest. These include:
- employees on moderate to low incomes, particularly those with incomes below about £15,000 a year (see Figure 1.1);
  - younger people, especially those in their 20s and 30s (see Figure 1.2); and
  - women, who are a significant majority of those with lower earnings in this target group (see Figure 1.3).

**Figure 1.1: Percentage of employees not contributing to a private pension by earnings band**



Source: Family Resources Survey 2004/05, UK

Figure 1.2: Percentage of employees not contributing to a private pension by age group



Source: Family Resources Survey 2004/05, UK

Figure 1.3: Breakdown of the target group, excluding higher earners, by gender and earnings



Source: Family Resources Survey 2004/05, UK

Notes: Private pension participation has been used as a proxy for participation in a pension with a 3 per cent or more employer contribution. Higher earners are defined as those earning £33,000 or over a year.<sup>3</sup>

<sup>3</sup> For this analysis the target group is defined as employees aged 22 to State Pension age (currently 65 for men and 60 for women), earning between £5,000 and £33,000 a year, and not in a private pension scheme.

- 1.3 The barriers which stop the target group from saving enough for retirement are:
- the complexity of the current pension system meaning the incentives to save are not clear;
  - the relatively high charges associated with pension products; and
  - a behavioural tendency not to act when faced with difficult financial decisions.
- 1.4 The Government is introducing legislation to tackle the first of these. A Pensions Bill with provisions to change the state pension system is currently before Parliament. Personal accounts, with automatic enrolment and a minimum employer contribution, are designed to tackle the second and third barriers to saving.

## Automatic enrolment

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- 1.5 The reforms to private pensions have been designed with people on moderate to low incomes in mind. In the May 2006 White Paper *Security in retirement: towards a new pensions system* the Government set out its proposals:
- employees will be eligible for automatic enrolment if their earnings exceed the lower limit of the PAEB of around £5,000<sup>4</sup> a year;
  - employee contributions will be around 4 per cent of their earnings between approximately £5,000 and £33,500 a year;
  - employees' contributions will be phased in over three years;
  - the employee contribution will be matched by 3 per cent from the employer, together with around 1 per cent from the State in the form of normal tax relief;
  - the PAEB, on which contributions will be calculated, will be updated in line with earnings to ensure contributions keep pace with incomes;
  - employees aged over 22 and below State Pension age will be eligible for automatic enrolment; and
  - employees outside these age bands will be able to opt in to the scheme.

<sup>4</sup> When launched, the limits for the PAEB will be aligned with the Primary Threshold and Upper Earnings Limit for National Insurance contributions (£5,035 and £33,540 a year respectively in 2006/07).

- 1.6 Evidence shows that automatic enrolment is one of the most effective ways of combating people's tendency not to act when faced with difficult financial decisions<sup>5</sup>. Automatic enrolment has the greatest impact among groups where participation rates are low. American research into 401(k) schemes showed that automatic enrolment had the largest effect among people with low incomes, minority ethnic groups and women.<sup>6</sup>
- 1.7 This does not mean employees will be compelled to save. The Commission rejected a compulsory approach to private saving because there will always be some individuals who should not or may not want to be saving towards a pension, for example, those paying off high levels of debt. However, the Commission argued that automatic enrolment was necessary to help people make the right choice for their retirement. In the May White Paper this approach to increasing the number of savers was endorsed by the Government.

"EEF supports the Government's proposals that employees should be automatically enrolled into a new pensions saving scheme with their employer also having to make contributions to the scheme if they decide to be auto enrolled."

(Engineering Employers' Federation White Paper response, September 2006)

"We believe the 'soft compulsion' of auto-enrolment represents the right balance between encouraging and forcing saving."

(Age Concern)

## How automatic enrolment will work in practice

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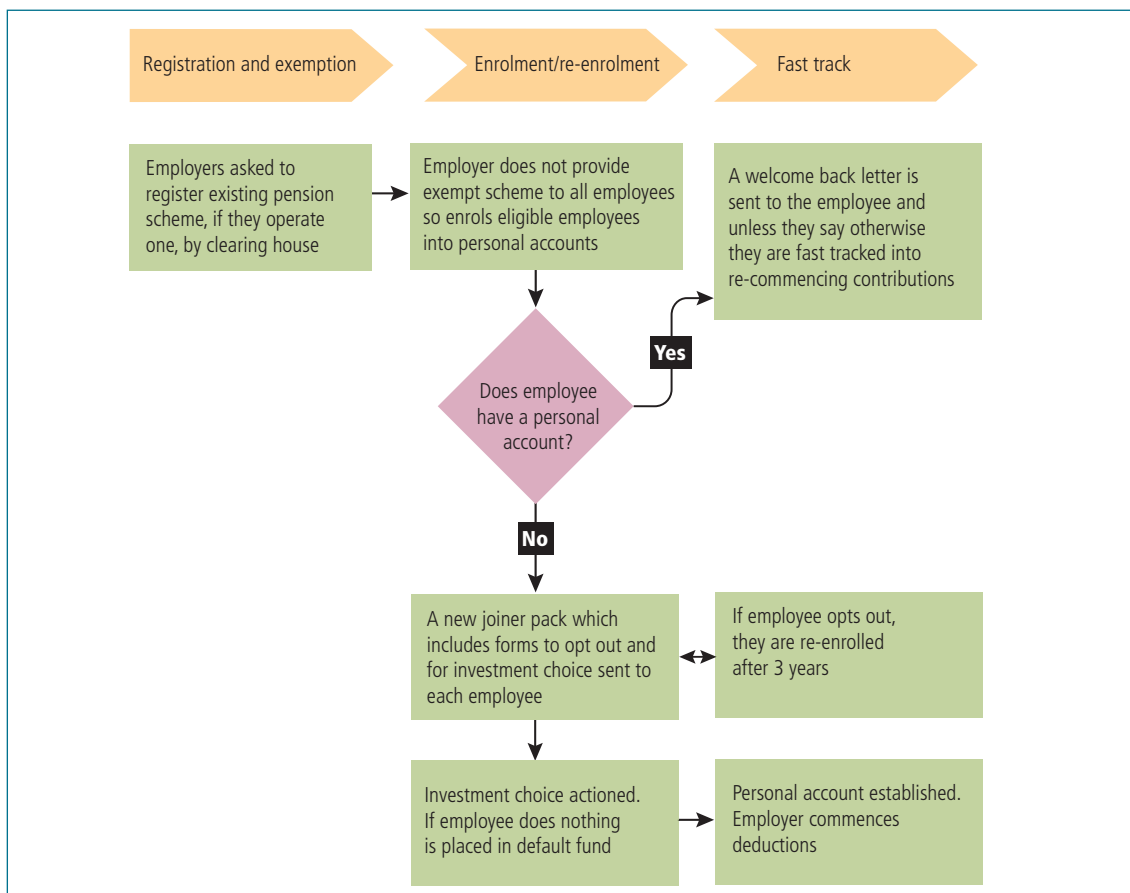
- 1.8 When an employee starts work they will be automatically enrolled into a pension – either into the employer's exempt pension scheme or into personal accounts. Employees over State Pension age may opt in to personal accounts and receive an employer contribution on qualifying earnings. Employees under 22 will not be automatically enrolled but may opt in to personal accounts.

<sup>5</sup> The *Employers' Pension Provision Survey 2005* findings show a link between automatic enrolment and increased levels of pension scheme membership. Within private firms with 20 or more employees, the proportion of employees that were in a pension averaged 60 per cent (median 77 per cent) where the firm used automatic enrolment. This compared with 41 per cent for traditional opt-in.

<sup>6</sup> Madrian and Shea, 2002, in Munnell and Sunden, 2004, *Coming up short: The challenge of 401(k) plans*, The Brookings Institute.

- 1.9 The Pensions Commission recommended an 8 per cent combined contribution with the goal of achieving an adequate minimum level of pension for most people. Based on their research<sup>7</sup>, they argued that the minimum the median earner wanted in retirement was 45 per cent of their working income. The 8 per cent contribution is intended to achieve that level, although actual outcomes will obviously depend on a number of factors, for example, investment returns.
- 1.10 Many people may want to save more. Contributions above the default minimum level from any people who do so would be eligible for tax relief (within existing rules and limits) but there will not be a requirement for an additional employer contribution.
- 1.11 Once personal accounts are up and running and a new employee already has a personal account from a previous job, the employee could be 'fast tracked' back into personal accounts. This would mean that contributions could be collected before the expiry of a fresh opt-out period (see Figure 1.4).

Figure 1.4: How automatic enrolment might work in practice



<sup>7</sup> Pensions Commission, 2005, *A new pension settlement for the twenty-first century: The second report of the Pensions Commission*, TSO.

## Who will be automatically enrolled

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### Earnings band

- 1.12 From 2012, everyone with annual earnings above approximately £5,000 will be automatically enrolled, either into a personal account or an exempt work-based pension scheme. The lower earnings threshold of the PAEB ensures that all but the very lowest earners are automatically enrolled. Anyone can of course opt out if they do not feel they can afford to contribute. However, certain groups on low earnings will want to save. For example, some people will be second earners who can afford to contribute and most people do not stay on low incomes for the whole of their working life.
- 1.13 The minimum contribution will be 8 per cent of gross earnings within the PAEB and will comprise a minimum 3 per cent employer contribution, an employee contribution of around 4 per cent and a State contribution of around 1 per cent in the form of normal tax relief.
- 1.14 Employees with earnings within the PAEB who are not already contributing to an exempt pension scheme or automatically enrolled into their employer's scheme will be enrolled into a personal account. Employees with an annual income below the lower threshold of the PAEB may opt in to personal accounts and would receive tax relief on their savings. In this case, there is no requirement for an employer contribution to be payable.
- 1.15 After the first year of operation, the PAEB, on which personal account contributions are calculated, will be linked to annual earnings growth.<sup>8</sup> This will maintain the value of contributions to personal accounts in relation to earnings.
- 1.16 This will also ensure that personal accounts continue to reach those in our target group with moderate to low incomes. If the lower limit for personal accounts reduced each year in comparison to earnings, more very low earners would be brought into personal accounts when State benefits may already provide a retirement income which they may consider adequate.

<sup>8</sup> Uprating the PAEB in line with earnings, after the first year, is likely to uncouple the PAEB from the National Insurance thresholds. However, it will maintain the value of contributions to personal accounts in relation to earnings.

## Minimum age for automatic enrolment

- 1.17 The May 2006 White Paper stated that employees should be automatically enrolled into personal accounts from the age of 22. This is in line with when people become eligible for the National Minimum Wage main rate. Age 22 was proposed in response to concerns about the administrative cost associated with frequent job turnover among the young, particularly students, which might reduce incentives to hire younger workers. Research shows job turnover slows by age 22.<sup>9</sup> In addition, there is evidence that the employment of younger workers is more sensitive to non-wage costs, which is why the minimum wage has a lower rate below age 22. Selecting age 22 strikes the right balance between the age when job tenure becomes more stable and encouraging employees to start pension saving at an early stage. Employees below the age of 22 may opt in to personal accounts and receive an employer contribution on qualifying earnings.

## Maximum age for automatic enrolment

- 1.18 The May 2006 White Paper stated that employers would continue to automatically enrol employees until they reach State Pension age. The recent *Financial incentives to save for retirement* analysis<sup>10</sup> published in November 2006 shows that most people close to retirement can still expect a good payback from saving in personal accounts or an equivalent exempt scheme. The employer contributions and normal tax relief effectively double the individual's contributions going into their personal account, so even if they receive Savings Credit immediately on retirement, they should get back more than they contributed.
- 1.19 As with other age groups, there is a small minority of older people who are at risk of a smaller payback from saving. For example, people who expect to be claiming Housing Benefit in addition to Pension Credit and Council Tax Benefit in retirement, though these people may be able to increase their payback by taking their pensions as a lump sum.<sup>11</sup>

<sup>9</sup> Labour Force Survey, spring/summer 1997 to winter/spring 2004.

<sup>10</sup> *Financial incentives to save for retirement*, November 2006, [www.dwp.gov.uk/pensionsreform/pdfs/financialincentives.pdf](http://www.dwp.gov.uk/pensionsreform/pdfs/financialincentives.pdf)

<sup>11</sup> The tax rules allow pension funds of less than £15,000 to be taken as a lump sum. Subject to the capital rules in means-tested benefits (and any other savings), the fund could have no effect on benefit entitlement. In addition, because home ownership among older households is relatively high, they are less likely to be affected by Housing Benefit.

- 1.20 Some commentators have argued that when personal accounts are introduced there should be a lower age limit for automatic enrolment, as individuals within a few years of retirement will not have time to build large pension funds through personal accounts or equivalent employer schemes. Alternatively, people nearing State Pension age may well have already built up some savings, so the personal accounts savings would not be the only source of funds. Even if they have, provided they have total funds below the trivial commutation limit (£15,000 in 2006/07) they could take this as a lump sum.
- 1.21 We would welcome views on:
- Whether there should be a cohort of employees approaching State Pension age at the time personal accounts are launched who should not be automatically enrolled into personal accounts.
  - Whether in practical terms, this might adversely affect the interests of this group, because they would be less likely to exercise the positive choice to opt in.

### Re-enrolment

- 1.22 People's circumstances do not stay the same. Individuals may choose to opt out of personal accounts at the outset, perhaps because they do not believe they can afford to save. A year or two later, their circumstances could be completely different but inertia may prevent them from doing anything about it. The Pensions Commission recommended that employees who opt out should be automatically re-enrolled every three to five years. The treatment for exempt schemes is dealt with in Chapter 6, but we agree that **employees who have opted out of personal accounts should be automatically enrolled again periodically.**
- 1.23 The May 2006 White Paper stated that **employees would be automatically enrolled** when they change employers and every three years if they continued to work with the same employer. Research shows individuals recognise how quickly people's circumstances can change.<sup>12</sup> Therefore, three years seems the right period.
- 1.24 We would welcome views on:
- Whether three years is the right period for repeat automatic enrolment of employees who have opted out of personal accounts.
  - How this would affect employers and employees.

<sup>12</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

## Self-employed

- 1.25 There are around 3 million self-employed people in the UK, of whom around 2 million are not saving in a private pension. The self-employed will be able to participate in personal accounts on a voluntary opt-in basis.
- 1.26 The Government considered whether the scheme should set a minimum contribution level for the self-employed, to guide them towards an income replacement rate. However, given the changeable cash flow that some of the self-employed experience, individuals remain best placed to decide how much they should save in a personal account. Therefore, **self-employed people will be able to save in personal accounts at a level of their choosing**, subject to the cap on contributions which applies to all members.
- 1.27 It will be important to help the self-employed to think about the amount they wish to save. The information that supports personal accounts will need to include the key messages and issues that the self-employed might want to consider when making savings decisions.

## Economically inactive

- 1.28 It is important that people can continue to contribute to their personal account during periods out of paid work, if they wish to do so. The scheme is being designed with this in mind.

## Individual contributions

- 1.29 The May 2006 White Paper proposed a minimum contribution level of 8 per cent, in line with the recommendations of the Pensions Commission. This was set at a level aimed at achieving a replacement rate of about 45 per cent of pre-retirement income for a median earner as recommended by the Pensions Commission.
- 1.30 The extent to which people save beyond the minimum will depend on how much they can afford to save. However, this is only one factor that will be relevant. Individuals need to understand the benefits of saving more and the process of increasing contributions will need to be simple. This is something that the body responsible for personal accounts will need to consider. Further details on the remit of this body can be found in Chapter 3.

## Conclusion

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- 1.31 Evidence shows that people have a tendency not to act when faced with difficult financial decisions. Automatic enrolment into a pension scheme has been shown to be one of the most effective ways of increasing pension saving, by introducing a presumption to save.
- 1.32 We propose that all employees between the age of 22 and State Pension age, with earnings above approximately £5,000 a year will be automatically enrolled into personal accounts or an equivalent work-based scheme.
- 1.33 The rate at which employees accumulate savings will be doubled thanks to matching their contribution of around 4 per cent, with a 3 per cent contribution from their employer and normal tax relief worth around 1 per cent.
- 1.34 Our goal is to develop a way that both encourages and makes it worthwhile for people to save for a pension, thereby giving them a reasonable expectation of being better off in retirement. We believe our proposals do just that.

## Questions for consultation

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We would welcome views on:

- Whether there should be a cohort of employees approaching State Pension age at the time personal accounts are launched who should not be automatically enrolled into personal accounts.
- Whether in practical terms, this might adversely affect the interests of this group, because they would be less likely to exercise the positive choice to opt in.
- Whether three years is the right period for repeat automatic enrolment of employees who have opted out of personal account.
- How this would affect employers and employees.

