

## Chapter 4: Minimising the burden on employers

- 4.1 *Security in retirement: towards a new pensions system* drew widespread approval from groups representing employers. The proposed reforms to both the state and private pension systems were welcomed as necessary measures to guard against pensioner poverty and promote private saving. In particular, employers recognised the long-term economic benefits of addressing the issue now, rather than waiting until the problems become acute. They also recognised that increased private pension saving wealth will benefit the economy as a whole.
- 4.2 The Government's reform programme continues to place employers at the heart of pension provision, and can only be successful with the support and involvement of employers. Many employers in the UK are already making a substantial contribution to their own pension schemes and are supporting their employees to save for their retirement. The Government's policy already supports this in many ways and we want to ensure our reform package also contributes to this. But for the reforms to be fully successful, those employers who do not already support pensions also need to play a role.
- 4.3 The Government's aim to minimise the burden of reform on employers has led to a series of proposals. These include:
- the level of the minimum employer contribution will be set by legislation;
  - the minimum employer contribution will be phased in over three years;
  - a criterion for deciding the delivery model is the burden on employers;
  - the criteria by which employers will gain exemption from automatically enrolling employees into personal accounts will be as simple and as straightforward as possible;
  - the personal accounts scheme, and the automatic enrolment processes, will be designed to focus on the target market and not to compete with existing employer schemes aimed at other market segments; and
  - the compliance regime will be light touch but effective.

- 4.4 This chapter considers issues such as waiting periods, employer contributions and administrative costs and focuses on:
- how employers with existing high quality pension schemes will be able to gain **exemption** from the requirement to offer personal accounts; and
  - how to implement the new requirements in a way that helps all employers **adjust to the new arrangements** as easily and quickly as possible.
- 4.5 Over the summer of 2006, the Government conducted several in-depth consultation exercises with employers and their representative bodies in order to help us analyse very carefully how the reforms could be designed to both promote existing workplace schemes and minimise the burden of any additional employer requirements.

## Exemptions for defined benefit (DB) and defined contribution (DC) schemes

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### Objective

- 4.6 An important objective for the design of personal accounts is that they supplement rather than replace existing workplace private pension provision. Therefore, the Government wants to exempt, from personal accounts, employers' pension schemes that provide broadly comparable or better benefits.
- 4.7 The current private pensions system is working well for many people who are saving for retirement. The Government wants to make it as simple and as straightforward as possible for employers with quality pension schemes to be exempted from the requirements to automatically enrol staff into personal accounts. To gain full exemption from personal account requirements an employer would have to automatically enrol all of their employees into the existing exempt scheme.
- 4.8 The Government has considered and consulted on options for occupational DC and DB schemes and proposals are based on a simple set of key criteria, self-certified by employers.

- 4.9 There is no common or universal definition of pensionable earnings and different schemes use different definitions. For some individuals and some sectors these differences are significant. The Government proposes that, for any benchmark test, the definition of earnings should reflect that used in personal accounts. This definition states that pensionable earnings includes all earnings between the level of the National Insurance Primary Earnings Threshold and the Upper Earnings Limit in 2012 when personal accounts are introduced. Thereafter, the personal accounts earnings band will be updated annually in line with average earnings.

## Defined benefit schemes

### Developing an exemption test for DB schemes

- 4.10 The Government wants to ensure that the exemption test is simple to operate and does not impose significant new burdens on employers or schemes.
- 4.11 For DB schemes, the benefit outcome is more relevant than the contributions going into the scheme so the Government ruled out a contribution-based test.
- 4.12 The Government also considered a test based on actuarial equivalence which involves converting an individual's accrued pension into a capital sum and comparing this with a notional money purchase pot based on an 8 per cent contribution into a personal account with an assumed rate of investment return. However, any test of equivalence that compares a DB pension with a DC fund would be complex and may require significant input from the scheme actuary which would increase costs for employers and their schemes.
- 4.13 A test for exemption for DB pension schemes should include the following criteria:
- a scheme-based test;
  - benefit accruals as a proxy for contributions in a personal account; and
  - automatic enrolment.

## Selecting a scheme-based test

- 4.14 The Government proposes a scheme-wide test based on an average of members' accrued rights. The Government believes that a scheme-based test represents an appropriate trade-off between simplicity for employers and ensuring parity of outcomes for individual savers against opportunities in personal accounts. Such a test already exists for DB schemes that are contracted-out of the State Second Pension (S2P) – the Reference Scheme Test (RST)<sup>1</sup>. This is a test of overall scheme quality, which ensures that contracted-out schemes provide generous benefits to individuals and in excess of the benchmark replacement rate of 45 per cent for a median earner. The test is based on a similar (but not identical) band of earnings to personal accounts. Therefore, the Government thinks that the RST could provide a 'passport' for exemption for contracted-out DB schemes. All contracted-out schemes could qualify for exemption – subject to operating automatic enrolment – without having to undertake additional activity.
- 4.15 Since the RST only applies to contracted-out schemes, a new test is needed for contracted-in schemes. The Government felt that any new test should be simpler than the RST and so has based it on a minimum accrual rate, comparable with a contribution of 8 per cent of earnings as defined for personal accounts. The Government has taken advice from the Government Actuary's Department (GAD) and proposes a minimum accrual of a 1/120<sup>th</sup> for contracted-in schemes.
- 4.16 The Government thinks that the two tests strike the right balance between outcomes for individuals and simplicity for employers and schemes. The Government has consulted key stakeholders on both options and there is general agreement that this is the right approach.

## DB contracted-out schemes: The RST

- 4.17 The RST is a test for DB schemes that are contracted-out of the S2P and it is a well established test which schemes are familiar with and have to satisfy to receive the contracted-out rebate, so it should not impose any additional burdens on employers.

<sup>1</sup> The RST is a test of overall pension scheme quality currently used for defined benefit pension schemes that are contracted out of State Second Pension. A scheme satisfies the test if the pensions provided to at least 90 per cent of the members are broadly equivalent to, or better than, the pension which would be provided under the Reference Scheme which is payable from age 65; is paid for life; accrues for each year of pensionable service (maximum 40 years) at the rate of a 1/80<sup>th</sup> of average qualifying earnings in the last three years of service; is based on qualifying earnings defined as 90 per cent of earnings between the Lower Earnings Limit and the Upper Earnings Limit; and provides for a 50 per cent survivor benefit for a spouse or civil partner.

- 4.18 In common with any scheme-based test, the RST has its limitations: it is based on an average of members' benefits across the scheme but also of individuals' benefits, of which, 90 per cent must pass the test. Also it is based on 90 per cent of qualifying earnings between the Lower Earnings Limit and the Upper Earnings Limit and allows for no more than 10 per cent of pensions to be less than RST benefits. The Government believes that these tolerances are acceptable because the RST provides generous pensions that (with the addition of the basic State Pension) will generally exceed the Pensions Commission's minimum replacement rate of 45 per cent for a median earner as shown in Table 4.1.

**Table 4.1: Replacement rate at retirement for a member of a scheme passing the RST**

Total replacement rate as a percentage of gross earnings in year before State Pension age		
Number of job changes in a lifetime	Average earner (%)	Lower earner (%)
One job	61	65
Five job changes	54	58
Six job changes	53	57
Nine job changes	51	55

Source: Government Actuary's Department, 2006

Note: An average earner is defined as having earnings at age 18 equal to 60% of median earnings for full-time workers, rising to 110% of median earnings at age 48 and older. The lower earner has earnings 20% lower than the average earner; that is earnings at age 18 equal to 40% of median earnings for full-time workers, rising to 90% of the median earnings at age 48 and older.

- 4.19 The majority of contracted-out DB schemes provide pensions based on final salary, but career average schemes can also pass the RST.

### DB contracted-in schemes: the minimum accrual test

- 4.20 The Government proposes a benchmark test for contracted-in schemes. Following advice from GAD, the Government proposes that the test be based on a minimum accrual of a  $1/120^{\text{th}}$ , calculated on the last three years of pensionable service, which targets a 45 per cent replacement rate for a median earner (including their basic State Pension and S2P). Table 4.2 shows that the estimated replacement rates for a low and average earner at retirement are expected to be well above the Pensions Commission's minimum 45 per cent replacement rate.
- 4.21 Additionally, the Government proposes that the benchmark test is based on all taxable earnings between a threshold of around £5,000 to £33,000 (as in personal accounts). To satisfy the test the average of all members' benefits across the scheme would have to be equal to, or better than, the benchmark scheme. With any test based on an average of members' benefits there is always the potential for some to accrue benefits below the benchmark.

**Table 4.2: Replacement rate at retirement assuming a member of a contracted-in DB scheme providing benefits in line with the qualifying schemes test for such schemes**

Total replacement rate as a percentage of gross earnings in year before State Pension age		
Number of job changes in a lifetime	Average earner (%)	Lower earner (%)
One job	58	63
Five job changes	52	58
Six job changes	52	57
Nine job changes	51	56

Source: Government Actuary's Department, 2006

Note: An average earner is defined as having earnings at age 18 equal to 60% of median earnings for full-time workers, rising to 110% of median earnings at age 48 and older. The lower earner has earnings 20% lower than the average earner; that is earnings at age 18 equal to 40% of median earnings for full-time workers, rising to 90% of the median earnings at age 48 and older.

## Analysis of the impact on all DB schemes

### DB contracted-out schemes

- 4.22 Latest estimates suggest that there are about 6,000 (private sector) contracted-out schemes with around 3 million members<sup>2</sup>. From its analysis DWP does not believe that the exemption test imposes any new costs for these schemes beyond those associated with automatic enrolment.

### DB contracted-in schemes

- 4.23 From its analysis, DWP estimates that some 1,500 contracted-in schemes have an accrual rate of at least a 1/100<sup>th</sup> and so should pass the test. Some 370 contracted-in schemes are shown as having no accruals – these schemes would not pass the test but the DWP believes that they are mainly frozen schemes and schemes in wind-up.<sup>3</sup>

<sup>2</sup> Source: Government Actuary's Department *Occupational Pensions Scheme Survey 2005*. Note: Schemes with 12 or more members.

<sup>3</sup> Source: Government Actuary's Department *Occupational Pensions Scheme Survey 2004*. The Survey does not collect information on schemes with an accrual rate of less than a 1/100<sup>th</sup>. Based on data from a small sample of schemes and therefore may be prone to significant error. Furthermore, the figures may include frozen schemes and schemes that have started to wind up.

- 4.24 The test will impose some costs on contracted-in schemes as, currently, they do not have to satisfy any kind of benchmark. However, the Government is proposing a simple test that in most cases the trustees or the employer should be able to certify without the need for actuarial advice.

### Summary of proposals on DB scheme exemption tests

- 4.25 For DB contracted-out schemes, the Government proposes using the RST for employers to pass in order to have their scheme exempted. This minimises any new costs to employers.
- 4.26 For DB contracted-in schemes, the Government proposes a minimum accrual test for employers to pass in order to have their scheme exempted. This will involve a small cost as such schemes do not currently have to meet any specific requirements.

### Defined contribution schemes

- 4.27 The Government believes that the following characteristics of DC pension schemes are significant in determining whether an employer should be exempt from enrolling employees into personal accounts:
- minimum overall contributions – underpinned by minimum employer contributions;
  - availability of a default investment option; and
  - automatic enrolment.

### Contributions

- 4.28 The White Paper proposals for personal accounts were based on the need for a minimum employer contribution of 3 per cent of taxable earnings within the band (£5,000 to £33,000). This improves incentives to save and is a building block to achieve the Pensions Commission's minimum 45 per cent replacement rate (State and private pension saving combined) for median earners.
- 4.29 Therefore, the Government thinks that any test – as its foundation – should have a similar requirement on employers. The vast majority of existing occupational DC schemes will meet such a requirement.
- 4.30 Similarly, the Government thinks that an overall contribution of at least 8 per cent of taxable band of pensionable earnings is essential if the Government wants to be confident in legislating to require employers to automatically enrol and achieve the 45 per cent target replacement rate figure for median earners.

- 4.31 However, whilst the Government thinks the 3 per cent employer and 8 per cent overall contributions are essential, a minimum employee contribution will not be required for scheme exemption. Some employers make more generous contributions than the 3 per cent minimum and the Government would want their schemes to be exempt as long as the overall contribution reaches the 8 per cent.
- 4.32 Around 14 per cent of employers operate employer contribution only schemes or schemes where employees can choose to contribute if they wish. Some of these schemes will have an employer contribution of 3 per cent or over but still not meet the overall contribution of 8 per cent.

### Proposals on contributions

- 4.33 In the exemption test, the Government proposes to set the default overall contribution within the test at 8 per cent, but allow an employee to actively opt for a lower contribution rate as long as the employer contribution is not below the 3 per cent minimum. While this is not ideal, in terms of potentially lower replacement rates in retirement and in terms of personal responsibility for individuals to save, the Government thinks this is the best way to recognise that such provision exists and it is desirable for it to continue.
- 4.34 With regards to Group Personal Pensions (GPPs) the Government wishes to continue to support these arrangements without disadvantaging employees. The Government will consult further on the treatment of non-occupational workplace pension arrangements.

### Charges

- 4.35 Low charges are a key feature of personal accounts – they have been designed so that charges do not significantly erode the pension fund being accumulated. Therefore, in the May 2006 White Paper the Government said that it needed to consider whether charges should be taken into account when designing an exemption test for DC schemes.
- 4.36 It is difficult to calculate exactly what additional contributions would be required to compensate an individual for higher scheme charges as it will depend upon individual circumstances throughout working life. However, the magnitude of the increase in contributions required is not inconsiderable; a median earner saving for 30 years would require an additional contribution of 0.5 per cent of salary above £5,000 to his or her scheme to compensate him or her for charges being 25 basis points higher.
- 4.37 However, analysis indicates that charge levels in workplace pension schemes are not high.<sup>4</sup> If current charge levels continue, this suggests that charges should not be a significant factor in designing any exemption test.

<sup>4</sup> Government Actuary's Department, *Survey of expenses of occupational pension schemes, 1998*.

## Options on charges

### Option 1: Take no account of charges

- 4.38 Since charge levels are not high for workplace pension saving they do not generally have a high impact on individuals' outcomes. Such an approach would be welcomed by the pensions industry.
- 4.39 To ensure individuals do not lose out, it would be possible to adopt this approach but take powers to review this situation in case charges significantly increase in expectation of implementation or after implementation of the reforms from 2012.

### Option 2: Make the exemption test more generous to indirectly compensate for charges

- 4.40 If the Government felt that some account ought to be taken of charges the test could be designed to make it more generous to the member and negate the need for taking charges directly into account. For example, the Government could define earnings from £0 rather than from around £5,000, or set employers contributions at 4 per cent of banded earnings. DWP estimates that these would have the effect of increasing employers' costs by £230 million or £200 million<sup>5</sup>, respectively and are significantly in excess of the impact of current charge levels on final pension incomes.

### Option 3: Take charges directly into account, for example net charges off contributions on a scheme-based basis

- 4.41 The Government has looked at this option, but concluded that it would be extremely complex to net charges, which are normally made against total funds under management, from contributions going in.

## Proposal on charges

- 4.42 The Government has proposed not to include charges as part of the DC exemption test – option 1 – but proposes to take reserve legislative powers to reconsider this approach if charges in these schemes cease to be comparable with those offered by personal accounts.

<sup>5</sup> Source: DWP analysis based on *Employers' Pension Provision Survey 2005*, *Small and Medium-sized Enterprise (SME) Statistics 2005*, *Annual Survey of Hours and Earnings 2005* and *Labour Force Survey 2006*.

## Funds

- 4.43 Within personal accounts individuals who do not make an active choice will be automatically enrolled into a default investment option. The Government envisages that in order to pass any exemption test, the qualifying scheme would also be required to enrol employees into a default investment option. Without this option it is difficult to see how such schemes could deliver automatic enrolment.

## Automatic enrolment

- 4.44 Schemes with an ongoing exemption will need to operate automatic enrolment. The later section on waiting periods announces consultation on possible flexibilities for automatic enrolment.

## Summary of proposals on DC scheme exemption tests

- 4.45 In recognising and encouraging existing employer pensions, the Government thinks that it needs to make the process of exemption as simple as possible for employers and schemes to understand and operate while still giving the necessary safeguards to individuals. Therefore, the Government has proposed the following criteria for DC scheme exemption:
- contribution rates of 3 per cent (employer) and 8 per cent (overall) of banded earnings;
  - charges not to be taken into account, but the Government will take powers to review this decision, if required;
  - a default investment option to be provided; and
  - operating automatic enrolment.

## The exemption process

- 4.46 The Government is aiming to make the exemption process as administratively simple as possible for employers and their schemes.

- 4.47 Stakeholder discussions have indicated that there is widespread support from employers for a process where they:
- are responsible for self-certifying that their scheme satisfies the exemption criteria; and
  - register their scheme as exempt from personal accounts.
- 4.48 The Government thinks that the employer (rather than their scheme) is best placed to ensure that all eligible employees are accounted for: being either automatically enrolled into their exempt workplace scheme or into a personal account. The employer also determines the eligibility criteria for automatic enrolment into their scheme and is responsible for commissioning RST certification from the scheme actuary; this approach would therefore be working within existing arrangements for contracted-out schemes. The Government anticipates providing employers and trustees with guidance to help with the self-certification process.
- 4.49 The employer's self-certification would be legally binding and sanctions within the compliance regime would apply for falsifying information.
- 4.50 The Government did consider whether the trustees should have lead responsibility for self-certifying the scheme because of their fiduciary duty to members. However, there are some practical difficulties with this approach. For example, where an employer is sponsoring more than one scheme and decides on the membership criteria for each scheme, the trustees might not be in a position to check that all eligible employees in the workforce have been automatically enrolled into an exempt scheme or a personal account. The Government thinks that the trustees could have a role in the exemption process by helping to police compliance. They might jointly sign any certificate with the employer.

### Frequency of the test

- 4.51 Re-certification might take place for:
- contracted-out schemes – when the actuary has to (re)-certify the RST; and
  - contracted-in schemes – on an exception basis where there has been a significant change, for example in the scheme's benefit structure or the definition of pensionable pay.

## Waiting periods

- 4.52 A waiting period is the length of time between commencement of employment and enrolment into a pension scheme. When considering whether or not to allow waiting periods in personal accounts and exempt schemes, there is an inherent trade off between two objectives: increasing individual saving on the one hand versus minimising burdens on employers and preserving existing provision on the other. The Government considered whether to permit waiting periods in exempt schemes and whether to require interim enrolment into personal accounts for those employers whose schemes have a waiting period.
- 4.53 Only a minority of workplace schemes – around 16 per cent – currently operate a waiting period<sup>6</sup>. Of these, around 80 per cent of the schemes do have a waiting period of at least a year, representing around 320,000 members. In 2000 this figure was 12 per cent or 200,000 members so this number is growing. Table 4.3 shows the number of members in schemes with waiting periods.

**Table 4.3: Active members of private sector schemes by length of service required for entry (millions)**

Minimum length of service for entry	Defined benefit	Defined contribution	Total
None	1.31	0.64	1.95
Less than one year	0.02	0.05	0.07
One year	0.03	0.04	0.07
More than one year	0.12	0.12	0.24
No response or closed to new members	2.11	0.14	2.25

Source: Government Actuary's Department Occupational Pensions schemes survey 2004

Notes: Includes schemes with 12 or more members only.

<sup>6</sup> Government Actuary's Department Occupational Pensions schemes survey 2004.

## Waiting period in personal accounts

### Option 1: No waiting periods in personal accounts

- 4.54 This proposal is based on the Government's objective of ensuring that all employees have the opportunity to save from the start of their employment. The Government thinks this is important because analysis shows that:
- individual outcomes could be significantly affected by the operation of a waiting period. Table 4.4 provides examples of the impact of waiting periods on final pension fund size;
  - waiting periods risk excluding casual and seasonal workers, and those changing employers frequently. This type of employee forms an important part of our target group for personal accounts;
  - participation in exempt schemes is likely to be affected by a waiting period as individuals are more likely to opt out when take-home pay reduces once the waiting period is over; and
  - any waiting period could produce an incentive for employers to employ staff on a short-term or temporary basis.
- 4.55 This position has been welcomed by some employer representative groups who argue that waiting periods would be administratively more burdensome because it would require employers to remember to enrol individuals.
- 4.56 The Government recognises that disallowing waiting periods will tend to increase the administrative burden and contribution costs to employers of personal accounts. But on balance, the Government believes these arguments do not outweigh the detrimental effects of waiting periods on outcomes and participation for the target group. The administrative burden would only be increased for the minority of employers who currently operate a waiting period.

### Option 2: Waiting periods in personal accounts

- 4.57 Data shows that 16 per cent of individuals change employer each year<sup>7</sup>, which implies that each individual, on average, changes employer once every six years. Over a 40–45 year working life, individuals would, therefore, on average, change employers around seven or eight times.

<sup>7</sup> Source Labour Force Survey 2006.

4.58 Table 4.4 shows the impact of waiting periods on final pension fund size assuming a 3 per cent employer contribution. A median earner (£23,000 a year) who saves for 43 years – assuming an annual management charge (AMC) of 0.5 per cent and a six months waiting period – would lead to their final pension savings being reduced by approximately 9 per cent if they had eight job moves over their lifetime. Those who move more often would face even more of a reduction in final fund size if a waiting period were allowed.

Table 4.4: Percentage reduction in fund size by waiting periods and number of job moves			
Waiting periods	Number of job moves over a lifetime (%)		
	8	16	20
3 months	5	9	12
6 months	9	19	23
12 months	19	37	47

Source: DWP analysis

Notes: Assuming a 3 per cent employer contribution.

Job moves are spread evenly over the lifetime.

4.59 Table 4.5 shows the impact on employer contributions and administrative costs of allowing a waiting period in personal accounts assuming everything else remains equal. The longer the waiting period, the greater the administrative saving for all employers who would automatically enrol some or all of their employees into personal accounts. However, the longer the waiting period, the greater the value of contributions employees would lose.

**Table 4.5: The reduction in employer contributions and employer administrative costs of allowing a waiting period in personal accounts**

Waiting periods	Contributions (£ million)	Administrative savings (£ million)
3 months	65–145	2–5
6 months	130–270	3–8
12 months	250–570	6–15

Source: DWP analysis based on Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005, Annual Survey of Hours and Earnings 2005 and Labour Force Survey 2006

Notes: Contributions are based on 2005 earnings and employment. They are not uprated to take into account earnings growth until 2012.

Uprating for earnings growth would increase the costs in nominal terms, but not as a share of labour costs or earnings terms.

Contributions are rounded to the nearest £5 million. Administrative savings are based on savings from not having to automatically enrol individuals who leave before the waiting period is over.

The cost of enrolling one employee into personal accounts is estimated to be between £3.50 and £9, dependent on whether the employee works for a small or large firm and whether they opt out or not.

Administrative costs savings are rounded to the nearest £ million and are in 2006/07 constant prices.

## Proposal for waiting periods in personal accounts

- 4.60 Based on the analysis above, the Government is not proposing a formal waiting period in personal accounts, although the Government recognises there will be a short period before the automatic enrolment process is completed. This is an area on which the Government continues to welcome views.

### Waiting period in exempt schemes

- 4.61 The Government has examined two options:

- no waiting periods; and
- a waiting period, for illustrative purposes, of six months.

These options are described and analysed below.

**Option 1: No waiting period in personal accounts. Where there are waiting periods in exempt schemes, employees must be automatically enrolled into personal accounts in the interim**

- 4.62 This option requires that employers who do not operate an exempt scheme, automatically enrol their employees into personal accounts from the start of employment. It allows for waiting periods in exempt schemes but requires that employees are automatically enrolled into personal accounts from the start of their employment as an interim to joining the exempt scheme.
- 4.63 During the Government's consultations with stakeholders it was made clear that waiting periods are often introduced as a reaction to high staff 'churn', so, by design, those changing jobs frequently are excluded from pension saving. However, these people are a key part of the Government's target group for personal accounts.
- 4.64 Some stakeholders also argued in favour of a waiting period, both for personal accounts and exempt schemes on the basis that:
- waiting periods reduce the administrative burden on employers, especially in sectors with high staff churn;
  - where people change employer frequently and join different employers' exempt schemes, lots of small employee pots may be created, which would be costly to administer; and
  - pensions are devalued if employees are enrolled from day one – some employers see pensions as a reward linked to staff loyalty.
- 4.65 Under this option, the Government would allow exempt schemes to retain their waiting periods, where these waiting periods do not otherwise threaten the scheme's exempt status. However, these employers would be required to automatically enrol employees into personal accounts in the interim. This minimises the disadvantages to individuals and allows employers to retain elements of their pension scheme that are important for their business.

**Option 2: No waiting period in personal accounts. For illustration, high-quality exempt schemes can have a waiting period, but employees are automatically enrolled into personal accounts after six months**

- 4.66 This option recognises that there is a risk that imposing too stringent a requirement on employers with exempt schemes may encourage employers to operate two tiers of pension provision: keeping their existing scheme for current members and enrolling new starters into personal accounts, which may be less generous.

- 4.67 It could also be argued that employers with existing high quality voluntary provision should be given some flexibility around waiting periods in 'reward' for what they already provide and to encourage them to continue to offer high quality provision.
- 4.68 Figure 4.6 shows that job 'churn' is greater in the first few months of employment. So there are arguments for allowing high quality exempt schemes some short-term flexibility.

**Table 4.6: Proportion of people employed by length of time working for current employer**

Length of time in current employment	Proportion of people employed (%)
0–3 months	5
3–6 months	3
6–12 months	8
<b>0–12 months</b>	<b>16</b>

Source: Labour Force Survey 2006

- 4.69 However, it is important to recognise the impact of allowing any waiting period on the Government's target group and the dilution effect it has on the Government's overall objective that all employees should be automatically enrolled into a pension – exempt employer scheme or personal account – from day one of employment.
- 4.70 This option illustrates the impact of allowing employers with high-quality exempt schemes to have a waiting period of up to six months before they were required to automatically enrol. If their scheme's waiting period exceeded the duration allowed then they would be required to automatically enrol into personal accounts after six months and until their scheme's waiting period expired.
- 4.71 During the course of consultation on personal accounts, some stakeholders argued that the Government should relax the requirement for automatic enrolment with no waiting period, particularly for employers who make contributions above the minimum for personal accounts. For example, this could operate in line with the National Association for Pension Funds (NAPF) suggested 'Good Workplace Pension' quality mark as described in the White Paper *Personal accounts: a new way to save*.

- 4.72 This option would provide greater flexibility to employers and would help to maintain existing employer provision. Employer contribution costs and administration could also be reduced for employers with such schemes. In addition, this option may potentially help keep the personal accounts annual management charge low as there are less 'small pots' to administer. However, this could also affect individual outcomes as it excludes members of the Government's target group such as those with regular changes of employer, casual, and seasonal workers. The Government will consult further on flexibility around waiting periods for high quality exempt schemes.

### The impact of Option 2

- 4.73 DWP estimates suggest that approximately 160,000 firms with 5.7 million employees are offered an employer contribution of greater than 6 per cent and 52 per cent of these employees are scheme members.
- 4.74 Approximately 3.8 million individuals – aged between 22 and 64 – begin working for a new employer every year. Of these, approximately 1.2 million work for an employer offering a contribution of greater than 6 per cent.
- 4.75 Analysis set out in Table 4.7 shows the impact of a six-month waiting period on these 1.2 million employees and their employers. This analysis suggests that employers with high quality exempt schemes would benefit largely in terms of reduced contribution and administration costs. However, this option is likely to significantly affect individual outcomes as it excludes members from the target group such as those with frequent changes of employer and casual and seasonal workers.

**Table 4.7: Impact of a six-month waiting period in schemes with a 6 per cent or higher employer contribution**

	Number of employees that work for an employer for less than six months	Number of employees that work for an employer for 6–12 months	Total number of employees that work for an employer for up to one year
Total number of employees	620,000	570,000	1,200,000
Cost to employer of making a 3% employer contribution into a scheme with no waiting period (£ million)	140	260	400
Cost to employer making a 3% employer contribution into a scheme with a six-month waiting period (£ million)	0	130	130
Cost to employer maintaining existing contribution levels into a scheme, no waiting period (£ million)	780	1,460	2,240
Cost to employer maintaining existing contribution levels into a scheme with a six-month waiting period (£ million)	0	730	730
Administrative cost saving to an employer with a scheme that has a six-month waiting period (£ million)	2.1–5.6	0	2.1–5.6

Source: Number of individuals and contribution cost estimates based on DWP analysis of Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005, Annual Survey of Hours and Earnings 2005 and Labour Force Survey 2006  
Administrative costs savings from DWP modelling

Notes: Contributions are based on 2005 earnings and employment, they are not uprated to take into account earnings growth until 2012. Uprating for earnings growth would increase the costs in nominal terms, but not as share of labour costs or earnings terms.

Estimates are based on a central opt-out assumption of around a third.

Administrative costs are in 2006/07 constant prices.

The cost of enrolling one employee into personal accounts is estimated to be between £3.50 and £9, dependent on whether the employee works for a small or large firm and whether they opt out or not.

Given that the employer would have to enrol those individuals who are still in the scheme after six months into something, the administrative costs savings would come from not having to enrol the 620,000 employees who will have left in those six months.

- 4.76 The cost of enrolling one employee into personal accounts is estimated to be between £3.50 and £9 dependent on whether the employee works for a small or large firm and whether they opt out or not. Given that the employer would have to enrol those individuals who are still in employment after six months the administrative costs savings would come from not having to enrol the 620,000 employees who will have left in those six months.
- 4.77 Allowing a waiting period may also lead to greater opt-out rates. There is evidence that people are more inclined to opt out if it enables them to avoid a fall in take-home pay – as would occur once the waiting period was over. In addition, this option may produce an incentive for employers to increase the length of waiting periods to six months in exempt schemes. Equally, it may encourage those employers with a longer scheme waiting period to reduce this to six months so that they are exempt from all personal account requirements.

### *Proposal for waiting periods for exempt schemes*

- 4.78 The Government will consult on Option 2 and in particular whether three or six months could be the best length of waiting period to balance the needs of employers and individuals within the target group. Whilst Option 2 reduces the risk of employers with existing high quality provision levelling down, it would reduce coverage for their employees in the first six months of employment.

## Phasing for personal accounts

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- 4.79 There will be a three year phasing in of employer contributions into personal accounts at 1/2/3 per cent with proportionate rates of employee contributions.
- 4.80 In the May 2006 White Paper we stated that all employers would either have to offer an exempt scheme with a 3 per cent employer contribution or level of accruals equivalent to this or contribute 3 per cent to personal accounts phased in over three years. The Government has consulted on whether this period should be longer for smaller employers.
- 4.81 The Government has looked at the costs to employers and impacts to individuals of three or five-year phasing which are shown in Tables 4.8 and 4.9.

**Table 4.8: Costs to employers of three or five-year phasing**

Total contribution cost	Year 1	Year 2	Year 3	Year 4	Year 5
Three-year phasing (£ million)	900	1,900	2,800	2,800	2,800
Five-year phasing (£ million)	900	1,400	1,900	2,300	2,800

Source: DWP analysis based on Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005 and Annual Survey of Hours and Earnings 2005

Notes: Phasing is 1 per cent, 2 per cent and 3 per cent for three-year phasing and 1 per cent, 1.5 per cent, 2 per cent, 2.5 per cent and 3 per cent for five-year phasing.

Contributions are based on 2005 earnings and employment. They are not updated to take into account earnings growth until 2012. Updating for earnings growth would increase the costs in nominal terms, but not as share of labour costs or earnings terms.

Estimates are based on a central opt-out assumption of around a third.

Figures are rounded to the nearest £100 million.

**Table 4.9: Impact on pension fund sizes of five year versus three year phasing**

Age of individual in 2012	Pension fund size with three year phasing (£)	Pension fund size with five year phasing (£)	Effect on fund size of five year phasing compared to three (%)
25	78,000	76,000	-2.9%
40	45,000	43,000	-4.3%
55	14,000	13,000	-11.2%

Source: DWP modelling

Notes: This applies to median earners, phasing is 1 per cent, 2 per cent and 3 per cent for three year phasing and 1 per cent, 1.5 per cent, 2 per cent, 2.5 per cent and 3 per cent for five-year phasing.

All monetary values are in constant earnings terms.

## Proposal for phasing in of personal accounts

- 4.82 In order to help employers adjust to the new arrangements, the Government concludes that the minimum employer contribution should be phased in over three years at 1/2/3 per cent – with proportionate rates of employee contributions – for employers offering personal accounts.

## Phasing for exempt schemes

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- 4.83 Without some form of phasing in of employer contributions in exempt schemes, in the first few years the growth rate in contribution costs for employers with exempt schemes could be higher than that for employers who are required to offer personal accounts.
- 4.84 For schemes that would just meet the exemption criteria, their eventual costs would be similar to those for personal accounts. Although they are starting from a higher base because they will already have a proportion of their employees enrolled before 2012.
- 4.85 Employers that offer schemes whose value is in excess of the exemption test level are starting from a higher cost base than personal account employers. Potentially, they will have significantly higher costs once implementation is completed.
- 4.86 Consequently, the Government has considered mechanisms to give employers of potentially exempt schemes time to manage the increase in costs associated with requirements for automatic enrolment.

### Option 1: Phasing in by contributions or accruals

#### For all new pension savers in exempt schemes

- 4.87 Under this option eligible employees are automatically enrolled in Year 1. However, contributions or accruals would be increased gradually in line with contributions of at least 1/2/3 per cent for personal accounts in Years 1/2/3, rising to the schemes actual level in Year 3.
- 4.88 Table 4.10 shows that if this option were implemented, 1.9 million employees of all exempt schemes would be automatically enrolled from Year 1. Contribution costs would be £200 million in Year 1 rising to £700 million in Year 3.

**Table 4.10: Phased contribution costs for all exempt employees**

	Year 1	Year 2	Year 3
Number of people in scheme (£ million)	1.9	1.9	1.9
Size of employer contribution (£ million)	200	400	700

Source: DWP analysis based on Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005, Annual Survey of Hours and Earnings 2005 and Labour Force Survey 2006

Notes: Contributions are based on 2005 earnings and employment. They are not uprated to take into account earnings growth until 2012. Uprating for earnings growth would increase the costs in nominal terms, but not as share of labour costs or earnings terms. Estimates are based on a central opt-out assumption of around a third.

### For exempt DB schemes only – enrol all non-members from Year 1

- 4.89 Phasing in contributions would not help employers running most DB schemes because these schemes would still be required to meet the RST during the phasing period and so are not able to reduce the benefits they offer in this way. Table 4.11 illustrates the impact of phasing accruals over three years.

**Table 4.11: Phased accrual costs for all into DB contracted in schemes**

	Year 1	Year 2	Year 3
Number of people in scheme	580,000	580,000	580,000
Size of employer contribution (£ million)	70	130	200

Source: DWP analysis based on Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005, Annual Survey of Hours and Earnings 2005 and Labour Force Survey 2006

Notes: Contributions are based on 2005 earnings and employment. They are not uprated to take into account earnings growth until 2012. Uprating for earnings growth would increase the costs in nominal terms, but not as share of labour costs or earnings terms. Estimates are based on a central opt-out assumption of around a third.

## Option 2: Phasing in by groups of employees

- 4.90 An alternative option would be to phase in by groups of employees over a period of time. Under this option we identified three groups of employees which would be treated in specific ways:
- new starters – automatically enrolled from the start of employment either into the exempt scheme or personal accounts;
  - those who have never had an employer pension offer of a similar quality to exempt schemes – automatically enrolled from the start of employment either into the exempt scheme or personal accounts; and
  - those who have previously declined their employer’s pension offer (either on an opt-in or opt-out basis) – automatically enrolled by the end of the phasing period either into the exempt scheme or personal accounts.

### **For all exempt schemes – enrol new starters and those previously not eligible in Year 1, all employees by the last year of phasing – at the full employer contribution for the exempt scheme**

- 4.91 Table 4.12 shows the distribution of employees being automatically enrolled over the three-year period and the associated contribution costs. Over half the employees would be automatically enrolled in Year 1. The cost to employers of a 3 per cent employer contribution would be higher in the first year (£300 million) compared to the base case of phased employer contributions at 1/2/3 per cent (Table 4.10).
- 4.92 If the employer maintains their current contribution level (assumed to be an average of 8.8 per cent), the costs are significantly higher for the employer.

**Table 4.12: Phased contribution by employee groups**

	Year 1	Year 2	Year 3
Number of people in scheme (millions)	1	1.2	1.9
Size of employer contribution (£ million):			
if 3%	300	400	700
if current contribution level	1,000	1,200	1,900

Source: DWP analysis based on *Employers' Pension Provision Survey 2005*, *Small and Medium-sized Enterprise (SME) Statistics 2005*, *Annual Survey of Hours and Earnings 2005* and *Labour Force Survey 2006*

Notes: Contributions are based on 2005 earnings and employment. They are not uprated to take into account earnings growth until 2012. Uprating for earnings growth would increase the costs in nominal terms, but not as share of labour costs or earnings terms. Three-year phasing is used to contrast the costs to the phasing period proposed for schemes running personal accounts. Estimates are based on a central opt-out assumption of around a third.

#### **For exempt DB schemes only – enrol new starters and those previously not eligible in Year 1, all employees by the end of the phasing period**

- 4.93 As already mentioned, there would be significant administrative complexities for DB contracted-in schemes to enrol new starters and those previously not eligible in Year 1, all employees by the end of the phasing period. For contracted-out DB schemes the costs would be significantly higher than under Option 1 (Table 4.11). This is especially true if the employer maintains their current average contribution levels of 12 per cent.

Table 4.13: Costs associated with group enrolment			
	Year 1	Year 2	Year 3
Number of people in scheme	300,000	360,000	580,000
Size of employer contribution (£ million):			
if 3%	100	120	200
if current contribution level	400	490	790

Source: DWP analysis based on Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005, Annual Survey of Hours and Earnings 2005 and Labour Force Survey 2006

Notes: Contributions are based on 2005 earnings and employment. They are not updated to take into account earnings growth until 2012. Uprating for earnings growth would increase the costs in nominal terms, but not as share of labour costs or earnings terms.<sup>8</sup> Estimates are based on a central opt-out assumption of around a third.

## Proposal for phasing on exempt schemes

- 4.94 In order to help employers adjust to the new arrangements, the Government will consult on phasing for exempt schemes and in particular which option – phasing by contribution or phasing by group – best meets the needs of both employers and the Government's target group. The Government will also assess the impact on DB schemes and whether or not they should be required to re-enrol those employees who have previously chosen not to save in their employer's scheme, as well as consulting on the appropriate phasing period for exempt schemes.

## Contribution costs and impacts – updated and new analysis

- 4.95 In the May White Paper the cost of a minimum employer contributions was estimated to be £2.6 billion (range £1.7 billion – £3.6 billion). The Government has re-estimated the cost to take into account updated datasets and our current estimate is £2.8 billion (range £1.7 billion – £3.8 billion). This increase in contribution costs has increased our estimate of the share of labour costs from 0.6 per cent to 0.7 per cent. Tables 4.14 and 4.15 give the results by firm size for Year 1 and Year 3.

<sup>8</sup> Three-year phasing is used to contrast costs to the phasing period proposes for schemes running personal accounts.

- 4.96 These estimates are not higher as a result of changes in proposals but because more recent datasets give higher numbers of employed people and higher wages. The estimates were reduced by a change in the target group to take into account recent analysis which identified more individuals who are saving in their employer sponsored provision. Otherwise the Government has not made any changes to the methodology since *Security in retirement: towards a new pensions system*.

**Table 4.14: Employer costs in Year 1**

Employer size (number of employees)	1–4	5–49	50–249	250+	Total
Cost of minimum employer contribution (£m)	100	300	150	350	900
Range (£m)	50–150	200–400	100–200	200–450	550–1,250
Percentage of labour costs (%)	0.4	0.3	0.3	0.2	0.2

Source: DWP analysis based on Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005 and Annual Survey of Hours and Earnings 2005

Notes: Assumes that contributions are phased in over three years starting with 1 per cent in the first year.

Costs before financial support to employers and before any pass through of costs.

Figures are rounded to the nearest £50 million, 2005 earnings.

Up-rating for earnings growth would increase the costs in nominal terms, but not as a share of labour costs or earnings terms.

Figures may not sum due to rounding.

**Table 4.15: Employer costs from Year 3**

Employer size (number of employees)	1–4	5–49	50–249	250+	Total
Cost of minimum employer contribution (£m)	400	900	500	1,000	2,800
Range (£m)	200–500	600–1300	300–600	600–1,400	1,700–3,800
Percentage of labour costs (%)	1.1	1.0	0.7	0.5	0.7

Source: DWP analysis based on Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005 and Annual Survey of Hours and Earnings 2005

Notes: Assumes that contributions are phased in over three years.

Costs before financial support to employers and before any pass through of costs.

Figures may not sum due to rounding.

Costs before financial support to employers and before any pass through of costs.

## Administrative costs – updated analysis

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- 4.97 Personal accounts will lead to some administrative costs for the employers. The Government is committed to minimising the cost to employers so has sought to achieve this in the design process of personal accounts.
- 4.98 Initially, employers will incur implementation costs. When an employer receives notification of personal accounts, they will need to satisfy themselves that they have the necessary information to enable them to take appropriate action. They will then need to choose whether to exempt their pension scheme or automatically enrol their employees into a personal account.
- 4.99 Employers who are not wholly exempt, and so offer personal accounts to some or all of their employees, will need to ensure that they have the necessary infrastructure and resources available to deal with the administration of personal accounts. These employers will incur an ongoing annual cost from activities such as<sup>9</sup>:
- supplying employee information such as name, address, National Insurance number to allow the issue of the joiner pack to the home address via personal accounts administration;
  - notifying the personal accounts administration of employees who leave and join; and
  - the collection of contributions.
- 4.100 In *Security in retirement: towards a new pensions system – Regulatory impact assessments and technical appendices*, early estimates suggested total set-up costs to all employers could be around £230 million, and total ongoing annual costs could be around £90 million, or about £10 per new scheme member.
- 4.101 DWP's revised estimates under the standard cost model (see the annex for further details) of the administrative burden are based on assumptions about the detailed processes employers need to undertake and the time that these will take. These assumptions are based on the minimum that DWP thinks employers would need to do to comply with new requirements and by including these as part of other Government requirements around payroll and PAYE. Estimates of total administrative costs are built up from the costs to individual employers and grossed up to national totals.

<sup>9</sup> Consultation will continue to take place following publication of the White Paper to determine how best to deliver these processes, taking into consideration how best to minimise the impact on employers.

- 4.102 However, there remains a degree of considerable uncertainty as the estimates are very sensitive to the assumptions made about the time and wage costs to carry out administrative activities, the number of businesses affected, the frequency with which the task must be carried out and other factors such as the cost of adapting payroll systems. They may also underestimate the higher compliance costs typically experienced by small firms resulting from lower levels of internal flexibility and higher adaptation costs. This includes a broader view on what activity employers may decide to undertake to comply with the regime and whether these are standalone activities could lead to significantly higher assumptions and therefore, estimates.
- 4.103 The methodology, datasets and assumptions used in the current estimates, which build on work by the Better Regulation Executive and Her Majesty's Revenue and Customs (HMRC) to measure administrative burdens, are set out in the technical annex to this Regulatory impact assessment.
- 4.104 The Government would welcome views on the processes and underlying assumptions that underpin these costings. These will evolve as a result of consultation as the Government nears implementation. In addition, DWP will set up a cross-government group of experts to work together on refining the assessment of the cost impact on employers. Implementation procedures will be altered, if necessary, to take account of any major revisions to the estimated costs to business, particularly small enterprises.
- 4.105 Tables 4.16 and 4.17 show the average administrative cost, during set-up and annually thereafter, by employer size, firstly per employer and then for all employers. Actual ongoing costs may be higher than DWP estimate in the initial years due to the time required for the process to be completely embedded. Although large employers carry a larger average burden per employer, as there are relatively few large employers, their share of the total administrative burden, and their cost per employee, is estimated to be much smaller.

Table 4.16: Average administrative cost per employer			
Number of employees in company	Year 1 cost (£)	Costs relating to implementation (included in Year 1 costs) (£)	Ongoing annual cost (£)
1–4	120	40	80
5–49	330	250	70
50–249	1,490	1,170	140
250+	6,090	2,420	900
All employers	250	140	80

Source: DWP analysis

Note: These are central estimates, which will vary with alternative opt-out rates and other assumptions.

Rounded to the nearest £10.

Table 4.17: Total administrative costs to employers (£m)			
Number of employees in company	Year 1 cost (£ million)	Costs relating to implementation (included in Year 1 costs) (£ million)	Ongoing annual cost (£ million)
1–4	94	32	60
5–49	120	92	27
50–249	39	31	4
250+	36	14	5
Total for all employers	291	169	96

Source: DWP analysis

Note: These are central estimates, which will vary with alternative opt-out rates and other assumptions.

Rounded to the nearest £ million.