

‘Making automatic enrolment work



13 August 2010

Summary

AEGON welcomes the Government's decision to review how automatic enrolment will work in practice, both for NEST and for other qualifying private sector schemes.

We have consistently supported the principle of automatic enrolment. If it succeeds, it has the potential to transform pensions saving in the UK and make it the norm for people in work to save for their retirement.

We have, however, also regularly raised concerns over some of the details of the policy. Indeed, the terms of reference for the review closely match some of the issues we discussed in our 'pensions manifesto'¹ ahead of the general election.

There have been voices which have argued for the existing arrangements simply to proceed as planned, as changing them now would cause delay or confusion. With the roll-out of automatic enrolment set to start in 2012, it's certainly important to clarify the policy framework sooner rather than later. So we welcome the speed with which the Government has moved to set up this review.

But automatic enrolment is a hugely important policy development – so it's important to get it right. We think the arrangements as they stand leave too much scope for implementation to go wrong. This in turn presents a reputational risk for automatic enrolment itself and for workplace saving more widely.

¹ *The Pensions Crunch – proposals for change* (AEGON, April 2010)

Reputational damage would lead inexorably but inevitably to policy failure. Mere compliance will be insufficient to deliver the desired result: that people save adequately for their retirement. As Turner noted, “the default rates will not secure the replacement rates to which many people will aspire”.² To achieve this will require individuals and employers to contribute at significantly higher rates than the bare minimum set out in legislation. They will not do this if they are not fully engaged with the process.

We have worked closely with the ABI throughout the pensions reform process and have been fully consulted and involved in the ABI's response to the review. In the main, we support the positions taken by the ABI, although a number of differences remain.

AEGON UK is part of the AEGON Group, one of the largest life insurance and pension companies in the world. In the UK we have pensions, life insurance, asset management and advice businesses. AEGON in the UK has assets under management of £55.7 billion, including revenue generating investments and employs around 4,000 staff. The AEGON Group has assets of around €361 billion (£320 billion).

² *A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission* (Pensions Commission, November 2005), p.358

1. The scope of automatic enrolment

Earnings threshold

AEGON strongly agrees with the ABI that the earnings threshold should be raised to around £10,000 a year. For the majority of workers, the employer contribution will mean it pays to save. For the very lowest earners, however, there is greater risk that this will not be the case. Putting the lowest earners on an opt-in basis – so that they could join a workplace scheme if they chose, with full access to employer contributions – would substantially reduce the number of people at risk of being automatically enrolled into a means-testing trap.

Contribution rates

Qualifying earnings should be defined in terms of full basic pay and not the complex 'band earnings' formula currently envisaged. Combined with raising the earnings threshold, this would have the effect of establishing a minimum contribution of around £65 a month (other than for those who opt in below the earnings threshold). This will give individuals more of a chance to build up a pension pot of meaningful value. It would also significantly improve the economics of automatic enrolment schemes, including NEST. This (along with the sensible dual charging structure put in place by the previous government) will help NEST repay its debt to taxpayers more quickly.

Using basic pay would also be in line with the vast majority of current market practice, making it simpler to administer and easier for both employers and employees to understand. It would also significantly help existing schemes at the point of transition. Under the existing legislation, there is a significant risk that employers will change to basing their contributions on band earnings in order to be sure they are complying with the legislation. In the majority of cases, this would result in lower employer contribution levels so that those being automatically enrolled would receive less benefit, and existing savers could actually receive lower employer contributions than they do at present.

Last but by no means least, a basic pay definition would also be fairer to most lower earners and to women. The 'loss' of the first £5,035 of pensionable earnings would unavoidably hit lower earners hardest in terms of qualifying earnings. Women are disproportionately represented among the lower paid; in addition, they tend to earn less of their total earnings from 'non-basic' elements.

Age limits

We do not agree that the current age limits (22 to State Pension Age) should apply from 2012. We propose that the upper age limit for automatic enrolment should be reduced to 55 initially, subject to review in 2017 and with older workers continuing to have the right to opt in (with an employer contribution) where they choose to do so.

In the early stages of the operation of automatic enrolment, many people will have reached this age without significant prior savings. In this case, they are unlikely to be able to accumulate sufficient savings in their remaining years of work. Older workers close to retirement would usually be expected to invest their contributions in low-risk, low-volatility funds that protect the value of their investment but do not offer a substantial return. In other words, compared to younger workers, who will be able to invest in funds with higher potential yields over a longer period, the burden of proof that it pays to save is reversed. In our view, while older workers should be entitled to opt in to a workplace scheme, they should not be automatically enrolled. It may not be best advice for them to take out a pension at such a late stage and they should be in a position to consider alternative savings vehicles, such as an ISA.

Some have suggested that trivial commutation will provide a solution for those with small pots. We would nonetheless have concerns about large numbers of older workers having to go through this process in order to 'get their money back' having been automatically enrolled in the first few years of the reforms. This would, in our view, represent a poor advertisement for automatic enrolment and pensions saving more widely. This may in turn have an adverse impact on the attitudes and behaviour of future generations.

The cost of setting up and then closing some of these short-term pension pots is also less likely to be recouped through charges and will have to be borne by the pension scheme membership as a whole.

It is to be hoped that a successful implementation of automatic enrolment – and the wider pensions reform programme – will mean future generations have higher levels of prior saving when they reach this age, which combined with a more generous state pension entitlement will mean less risk that it will not pay to save.

The existing legislation has scheduled a wide-ranging review for 2017 and we believe this would be an appropriate juncture to reconsider the upper age limit.

Small firms

We are also not convinced that the policy should attempt universal coverage of firms, regardless of size. Instead we propose that – reflecting the current exemption for designation of a stakeholder scheme – firms with fewer than five employees should be removed from scope in the initial stages of automatic enrolment.

We are concerned that the task of communicating the changes and of policing compliance among the large number of very small employers, will prove extremely onerous. There is a reputational risk to the policy in that promising blanket coverage which is then effectively denied to those working for non-compliant small firms, will lead people to question the claims made for pensions saving in general.

In the fullness of time, when compliance procedures are more fully bedded in, it may be possible to expand coverage to these firms and their employees. Again, we believe that

this can be reconsidered, with the benefit of evidence from the actual operation of these procedures, as part of the scheduled 2017 review.

Waiting periods

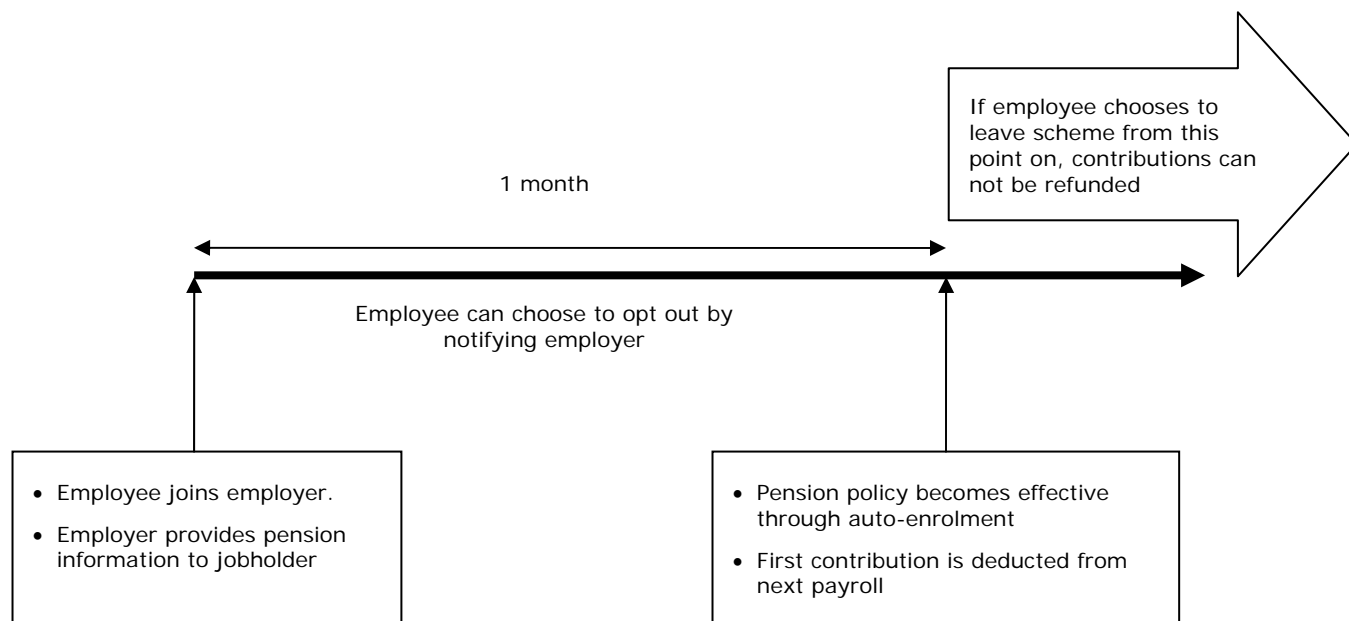
Opt-outs are expected to be high, with some commentators suggesting it could be as much as 30-40 per cent of those automatically enrolled. Workers opting out are expected to include a high proportion of people who move jobs on a regular basis, temporary workers and migrant workers.

Our experience of working with employers indicates most employers will want to avoid the need for refunds. In addition to making the contribution in the first place, for opting out employees, the employer will need to inform the provider or NEST that the employee has opted out, manage and reconcile the refunded contribution and then repay back to the employee, who may no longer work for them by that stage. These multiple hand-offs will be costly for the employer to administer, are bound by time restrictions and present a high risk of error.

For employees who choose to opt out, they have to wait for one or two payroll periods before they receive their contribution refunds. For lower earning workers, who are probably more likely to opt out, this could present unnecessary challenges if they are already living on a tight budget. For workers who move jobs on a regular basis and in some cases do not have a bank account, there is a risk that they will never actually receive some of their refunds.

It is also costly to providers to administer – a cost which will inevitably be passed on to other scheme members. This is both avoidable and unfair.

One way to avoid individuals, employers, providers and NEST having to meet the cost of refunding contributions to workers opting out, would be for no contributions to be taken until after the opt-out period has been completed. To avoid employers having to hold contributions until after this period, we propose that the effective date of the pension contract is not until after the end of the opt out period:



2. Can the market serve the automatically enrolled population?

Where the review refers to 'the potential automatically enrolled population', we take this to mean people who are not currently enrolled in a workplace scheme but who will be eligible for automatic enrolment under the Pensions Act 2008. Over time, of course, many people who are already in a scheme will themselves be automatically enrolled, for example if they change employment.

The fact that the market currently provides well for higher earners and larger employers should not obscure that it can, and in many cases already does, provide also for lower earners and smaller firms. Within schemes, there is often a wide range of individual earnings and contributions so that existing schemes serving what is generally thought of as the 'high end' of the market, will also cater for low and moderate earners.

We currently operate on the basis of bespoke scheme pricing, which involves an assessment of, amongst other things, likely contribution levels and persistency of the potential scheme membership. Our charge levels reflect this assessment. Bigger schemes with stronger income profiles and higher employer contributions will tend to attract lower charges; smaller schemes with lower earners and lower employer contributions will tend to feature somewhat higher charges. This is in the nature of a business with a large element of fixed and upfront costs.

The reforms will require firms without existing provision to put a scheme in place for their employees. In many of these cases, the profile of these firms will be such that providers – including AEGON – will wish to compete for their business just as they do in the current marketplace. As indicated above, these schemes will include low and moderate earners along with their higher-paid colleagues, and will often include smaller firms.

In principle, bespoke pricing would enable providers to set an economic price for any scheme. However, it seems clear there will be some firms it would be impossible to serve profitably without significantly higher charges than current market norms. This would further bring into question whether it was in the interests of lower earners in particular to stay in these schemes and would be, in our view, unacceptable to employers and Government/regulators.

Implementing some or all of the proposals above regarding the scope of automatic enrolment would significantly mitigate this risk. In particular, raising the earnings threshold, and basing contributions on full basic salary, would have a major impact on the economics of provision and make it possible for the private sector to serve a much greater proportion of the automatically enrolled population within an acceptable charging envelope.

In practice, however, we find it difficult to envisage a scenario where there are no schemes which would be uneconomic for the market to serve, especially in the current climate of scarce capital. In order to ensure that employees can be automatically enrolled – and have access to the contingent employer contributions that go with that – it is necessary to have a mechanism to deal with these cases. This is precisely the need NEST was designed to meet.