NAPF

Securing the future of pensions

More Savers, More Saving?

How employer decisions will determine the long-term success of pension reform

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Executive summary

From 2012, employers with good pension schemes will have to choose whether to automatically enrol their employees into these schemes or into the new system of Personal Accounts. They will also have to decide whether to set contribution rates at the minimum level permitted or to extend the higher contribution rates typical of existing provision to more employees.

These decisions matter. Under the 2012 reforms, employer contribution rates can be as low as 3% of earnings between £5,000 and £33,500 (with employees paying a further 5%). Today, a typical defined contribution pension includes an employer contribution worth more than twice as much as this. Employer contributions to defined benefit schemes are higher still.

Most employers will be faced with substantially higher pension costs when required to use automatic enrolment as take-up rates tend to be lower when schemes operate on an opt-in basis (often around 50-60%) than when auto-enrolment is used. Faced with this increase in costs, some employers may level down their provision – that is to say they may choose to auto-enrol people on less favourable terms than would be available on an opt-in basis.

More Savers, More Saving? considers how employer reactions to the introduction of Personal Accounts will determine the type of pension provision available in the future and its value to employees. In particular, it examines how the extent of levelling down may affect overall saving levels. The analysis is based on research and modelling undertaken for the NAPF by Deloitte[1]. The key findings drawn from this analysis are:

- While pension reform will result in more savers, the amount of extra saving will vary substantially according to how employers respond to pension reform.

- If employers choose to auto-enrol their employees at the contribution rates that would be available without pension reform (in other words, if there is no levelling down), employer contributions in 2026 will be one-third higher than if employers react as Deloitte's Pension Reform in the Workplace model suggests they may[2]. That would increase the annual value of employer contributions in 2026 by £5 billion (in today's earnings terms). And total employer and employee contributions could be almost £10 billion higher if there is no levelling down compared to our worst case scenario.

[1] NAPF commissioned Deloitte & Touche LLP to model the possible impact of pension reform on employer schemes and how this impact might affect the outcomes of pension reform. The views expressed here are those of NAPF except where expressly otherwise stated.
[2] Deloitte's Pension Reform in the Workplace model was developed from original research among employers with pension schemes.

- The modelling indicates that for employees who currently benefit from a workplace pension, pension reform could result, on average, in employer contributions falling by about 2% of salary over the long run. Separate NAPF analysis suggests that someone on average earnings who is in one of today's typical DC pensions can expect to be about £3,000 a year better off in retirement than they would be from saving for the same period in Personal Accounts at the minimum statutory contribution level.

- If instead of putting employees into Personal Accounts, all employers offering a pension choose to place their employees in their own pension arrangement, Personal Accounts will be a targeted intervention and serve about one-fifth of those private sector employees saving in a pension. However, if employers react as the model suggests they may, a majority of private sector employees saving through the workplace will eventually be in Personal Accounts.

- If levelling down can be avoided, the long-term level of defined benefit scheme membership could be three times as high if employers behave as the model suggests they may. In the long run, this would mean that nearly one million more private sector employees could save in defined benefit schemes each year.

There is no doubt that some employers will respond to the 2012 reforms by altering their pension provision. However, large scale levelling down need not be inevitable. If good quality workplace pensions are supported, and if Personal Accounts are implemented in a way that minimises the impact on existing provision, levelling down can be the exception rather than the rule. The NAPF believes good workplace schemes can be maintained if:

- Personal Accounts are carefully designed to meet the needs of the target group – those who do not have access to a workplace pension with an employer contribution – and a simple, flexible, test is used for assessing when an existing scheme is a suitable alternative to Personal Accounts;

- The Delivery Authority for Personal Accounts is officially tasked with taking account of the impact of the new regime on existing provision in its recommendations for the design of Personal Accounts to Ministers;

- The Government provides support for existing provision through fiscal measures that would ease the cost pressures faced by employers wanting to auto-enrol all employees into schemes with high contribution rates; and

- Measures such as the Good Pensions Mark proposed by the NAPF help employers to demonstrate the value of the pension on offer to current and prospective employees.

1. Introduction

To tackle the problem identified by the Pensions Commission of up to 12 million people either not saving or not saving enough for retirement, the Government plans to introduce a new system of Personal Accounts, supported by auto-enrolment and mandatory employer contributions, from 2012. The NAPF welcomes this development. Properly designed and implemented, Personal Accounts will extend retirement savings to groups that have historically been excluded from pensions. There is no doubt that Personal Accounts could play a role in achieving the step change in savings behaviour that the Government desires.

But the introduction of Personal Accounts cannot be viewed in isolation. Personal Accounts are a significant intervention in the pensions market and their presence will have an impact on existing provision, as the Government itself has recognised. This impact may not be unambiguously positive.

There can be little doubt that auto-enrolment is an effective way of getting people to save, boosting pension scheme membership by 20%-50%[3]. But it is also clear that, for private sector employers, auto-enrolment remains a minority sport. The DWP estimate that just 3% of private sector employers already contributing above the Personal Accounts minimum currently use auto-enrolment[4]. So for many, the Government's pension reform package will increase the costs of providing pensions.

These costs are not trivial. The NAPF estimates that the additional costs of auto-enrolling all eligible staff into a pension scheme on existing terms would be between £1.5 billion and £2.5 billion a year for employers offering contributions above the minimum required by Personal Accounts.

Faced with these additional costs, there is a risk that employers may 'level down' their existing schemes and offer lower contributions going forward. Levelling down in this context means enrolling employees into schemes on less favourable terms than would have been available without pension reform. Just like the closure of final salary schemes to new members, this would reduce the value of pension provision over time, even if existing members are not affected until they change employer. When Ministers say they do not want pension reform to cause further levelling down, this should mean that they want employers with good schemes to auto-enrol people on the terms which would have been available on an opt-in basis.

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[3] See *Quantity vs Quality*, NAPF, June 2006, pp11-18.
[4] *Hansard*, 7 November 2006, col.1135w. The 3% of companies account for 20% of employees in such companies.

Why does levelling down matter?

Where people are already saving in workplace pensions, these are usually more valuable than Personal Accounts will be:

- A typical defined contribution scheme has an employer contribution more than twice as high as the minimum contribution to Personal Accounts. Average contributions to defined benefit schemes are higher still – around 16% of pensionable pay, according to one recent survey[5].

- The resulting pensions are more valuable than those that will be generated by Personal Accounts. A man on median earnings saving through a typical DC scheme for 40 years can expect this pension to replace around 21% of earnings at the point of retirement, compared with a 15% replacement rate from Personal Accounts. In a typical DB scheme, he might expect a replacement rate of around 36%[6].

The Government has said that the White Paper reform package must be for the long term. We agree. The reforms will ultimately be judged on how they affect pension adequacy over several decades. The Government must therefore take account of the impact of Personal Accounts on levels of saving not just at the point of introduction but also over the long term. In common with others, the NAPF is concerned that unless steps are taken to prevent levelling down at the outset, there will be a steep decrease in the availability of good quality pension provision over time.

Levelling down is not inevitable

There is no doubt that some employers will respond to the 2012 reforms by altering their pension provision. However, large scale levelling down need not be inevitable. The NAPF has proposed a Five Point Plan for Better Pensions, designed to make levelling down the exception rather than the rule.

We look forward to working with Government and others over the coming months to develop these proposals in order to help support the good quality pension provision on which so many depend.

[5] *Occupational Pension Schemes 2005*, Government Actuary's Department, p94.
[6] The assumptions used in these calculations are listed on p47 of the NAPF's response to the White Paper. The estimate for DB schemes assumes that not all earnings are pensionable and attempts to strip out benefits derived from contracted-out rebates.

Box 1: NAPF five point plan for better pensions

1. A ***Good Workplace Pension Quality Mark*** for employers offering schemes above the Personal Accounts minimum and who meet set criteria.

2. ***Financial incentives*** for employers that make contributions of at least 5% of gross earnings – around twice the Personal Accounts minimum.

3. ***Ring-fencing Personal Accounts*** from existing provision by prohibiting transfers in or out.

4. ***A simple, flexible "suitable alternative scheme test"*** that takes account of contributions, costs and charges and scheme waiting periods.

5. ***Transitional measures*** on contribution ceilings for Personal Accounts, and waiting periods for existing schemes to help employers adjust to the additional costs of auto-enrolment (to be reviewed after 10 years).

Above all, we believe the new Personal Accounts regime should be designed so that employers who are already offering a more valuable pension extend it to the entire workforce, leaving Personal Accounts as a targeted intervention to serve those currently without access to a good workplace scheme. One way to address this would be to ensure that the Delivery Authority being set up to help design Personal Accounts has a duty to consider the impact of its actions and recommendations on existing provision. This requirement should be incorporated into the Authority's terms of reference.

2. The employer response to pension reform

It is difficult to know how employers will react to pension reform when it takes effect in 2012. Many, no doubt, have yet to give the subject any thought. Indeed, in a recent DWP survey[7], a majority of employers currently contributing more than the proposed 3% minimum said they had not even heard of the National Pension Savings Scheme. Moreover, 59% of these employers did not think the 2012 reforms would increase their pension costs. It is clear that, for many, this view will be mistaken, as only a minority use auto-enrolment today. Most of the remainder will therefore find themselves paying contributions for more people when required to use auto-enrolment.

Nevertheless, there is general agreement that the introduction of Personal Accounts will cause many employers to review their pension provision. In addition, various surveys have highlighted the risk that many employers may level down. For example, Capita Hartshead found that only 42% of large companies would auto-enrol new and existing staff into the existing scheme on current terms[8]. In the DWP's own survey, 60% of employers currently contributing more than the Personal Accounts minimum said they would seek an exemption from Personal Accounts and auto-enrol everyone into their existing scheme either on existing terms or at a lower contribution rate[9].

In light of this uncertainty, NAPF asked Deloitte to estimate how the outcomes of pension reform may vary, depending on how employers with good schemes respond to the changes.

The initial step was to consider how pension provision might be expected to develop in the absence of pension reform – the counter-factual. Taking account of recent trends, we assumed that some levelling down would take place regardless of whether the Government's proposals are implemented or not, reflecting the ongoing closure of defined benefit schemes to new members. In the long term[10], this would reduce membership of private sector DB schemes to around one third of its current level – broadly in line with the Pensions Commission's projections. Overall membership of private sector workplace pensions is assumed to remain unchanged.

Full details of the assumptions made regarding scheme membership and contribution levels are set out in Annex 1. Given the long-term nature of the study, there is likely to be some uncertainty regarding the projections. However, they do provide a valuable indication of the future direction of workplace pension provision.

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[7] *Employer Attitudes to Personal Accounts: Results of a quantitative study*, BMRM/DWP, November 2006, pages 37 and 70.
[8] NAPF analysis of Capita Hartshead *Pension Administration Survey 2006*.
[9] *Employer attitudes to personal accounts: results of a quantitative study*, BMRM/DWP, November 2006, p83.
[10] Throughout this report, calculations showing what might happen in "the long term" are based on 2056. However, most of the reported changes are shown to take effect long before this date.

Having created this baseline ('no pension reform' in the graphs that follow), Deloitte then mapped three different sets of employer responses based on assumptions agreed with NAPF and incorporating the impact of pension reform. In each case, the analysis shows how outcomes will evolve over time as employees who change jobs are offered less valuable pensions than their predecessors. The three scenarios are set out in Box 2:

Box 2: Three Scenarios

No Levelling-Down: Where employers already offer pensions worth more than the Personal Accounts minimum, all employees are auto-enrolled into the existing scheme on existing terms. Contribution rates are reduced to take account of the ongoing shift from DB to DC provision, but no further levelling down takes place. People working for employers without workplace pensions are auto-enrolled into Personal Accounts at the minimum contribution level. *Result – high level of contributions and no displacement of existing pension provision.*

Modelled Employer Response: Employees working for employers already offering a pension are auto-enrolled either into that scheme or into Personal Accounts at a range of contribution rates, in accordance with a model prepared by Deloitte. The Pension Reform in the Workplace (PRW) model takes account of employers' responses to a survey about their likely reactions to the 2012 reforms as well as other information that Deloitte holds about different firms (such as their trading and recruitment expectations, their attitude to provision of benefits, the cost of auto-enrolment into their existing scheme and the profile of their workforce). Employees working for employers without a workplace pension are assumed to join Personal Accounts at the minimum contribution level. *Result - pension reform results in substantial levelling down of contribution rates and material switching from existing provision to Personal Accounts.*

Severe Levelling Down: 20% of employers currently offering a pension worth more than the Personal Account minimum apply auto-enrolment to this scheme from 2012. The remaining 80% close their schemes to new entrants from 2012 and auto-enrol people into Personal Accounts at the minimum contribution levels. Existing members can continue benefiting from higher contributions for as long as they remain with the same employer. Employees working for an employer with no pension provision are auto-enrolled into Personal Accounts at the minimum contribution level. *Result - rapid reduction in contribution rates and widespread switching from existing provision to Personal Accounts.*

None of the three scenarios are forecasts. Instead, they are designed to show how, for all the uncertainty surrounding pension reform, it is clear that the responses of employers currently offering good schemes will be a key determinant of the policy's success.

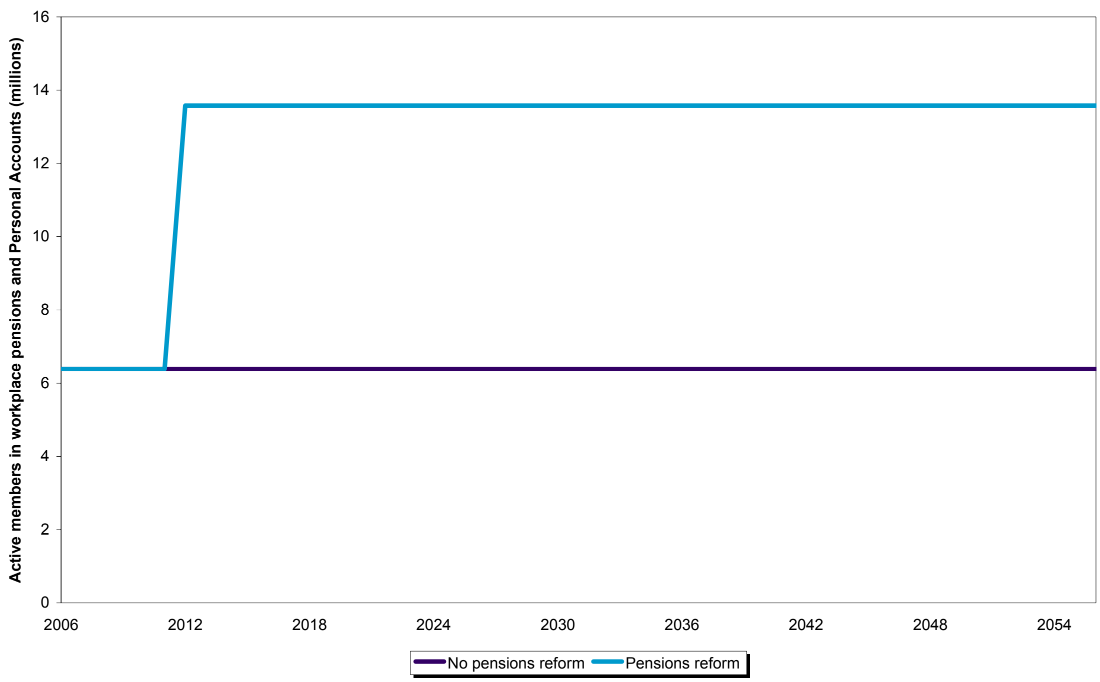
3. More savers, more saving?

Pension scheme membership

Total number of savers

Our analysis suggests that pension reform could increase the number of private sector employees saving for retirement through the workplace from 6.4 million to 13.6 million[11]. By producing a lot more pension savers, auto-enrolment can be expected to satisfy the first half of the Government's 'more savers, more saving' objective[12].

Figure 1: Total membership – outcomes compared



However, employer reactions to pension reform are shown to have a significant bearing on the types of pension in which people save and on the value of contributions – so it is less certain how much more saving will be achieved.

Where people are saving

In all of the scenarios considered, the introduction of auto-enrolment temporarily boosts the number of people saving in DB schemes in 2012 (see figure 2). But unless levelling down can be avoided, this effect will be short-lived. Staff turnover will quickly reduce

[11] Some data sources suggest there are more than 6.4 million private sector employees saving through workplace schemes today, while others suggest that fewer private sector employees are doing so. The justification for this number is set out in Annex 1.

[12] The White Paper says the Government's "first priority" is to "make it easier for more people to save more for their retirement" (p16). As the Government has recognised, some of the money saved for retirement through Personal Accounts may displace saving in non-pension vehicles.

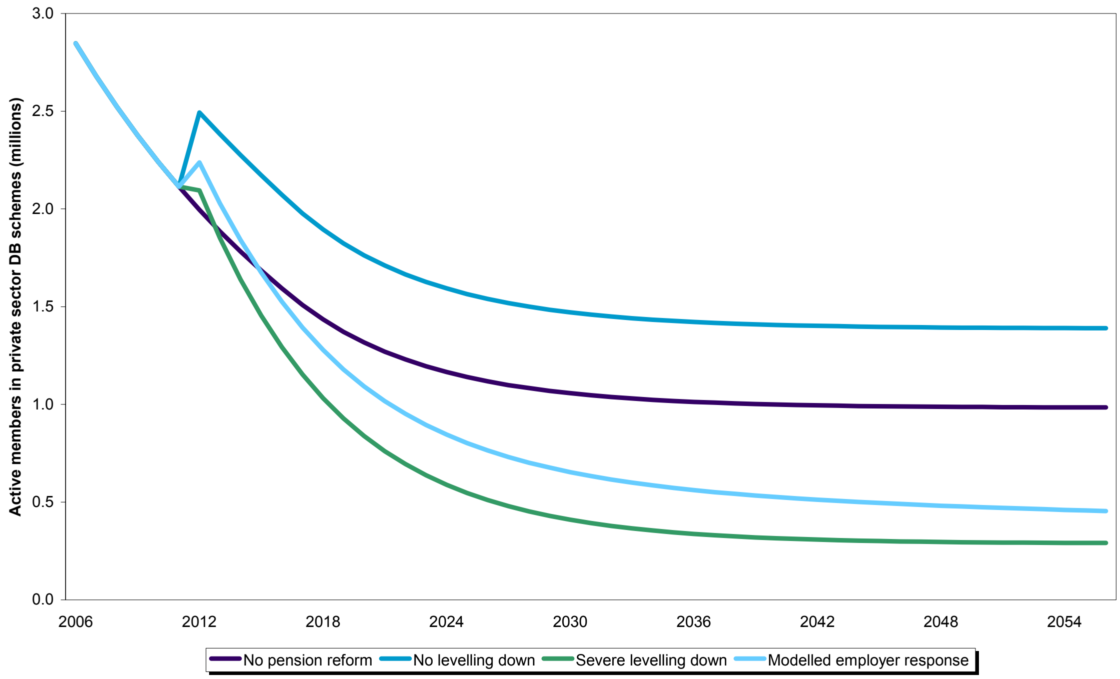
membership of schemes that close to new entrants as a result of pension reform, offsetting the increase in participation rates delivered by auto-enrolment. If employers respond as Deloitte's PRW model suggests they may, the effect of pension reform on DB membership will become negative within three years.

If levelling down can be avoided, there could still be 1.5 million active members of private sector DB schemes in twenty years' time. But if employers level down as the 'modelled employer response' suggests they may, there could be only half as many people saving in these schemes.

This gap would get wider over time. In the long-term, there would be 0.5 million active members of DB schemes if employers react in line with the 'modelled employer response' – half the number there is assumed to be without pension reform. Without levelling down, however, the figure could increase to 1.4 million. There may therefore be around one million more people saving in DB schemes each year if existing provision is effectively supported.

In reality, each DB 'place' that is preserved will improve retirement outcomes for more than one person. This is because people may spend part of their careers with employers who continue to offer DB schemes and part with other employers. If an extra one million people have access to DB schemes each year, several million will benefit from some DB provision during their working life. This would offer a degree of security to individuals who are being asked to shoulder increasing amounts of longevity and investment risk as they prepare for retirement.

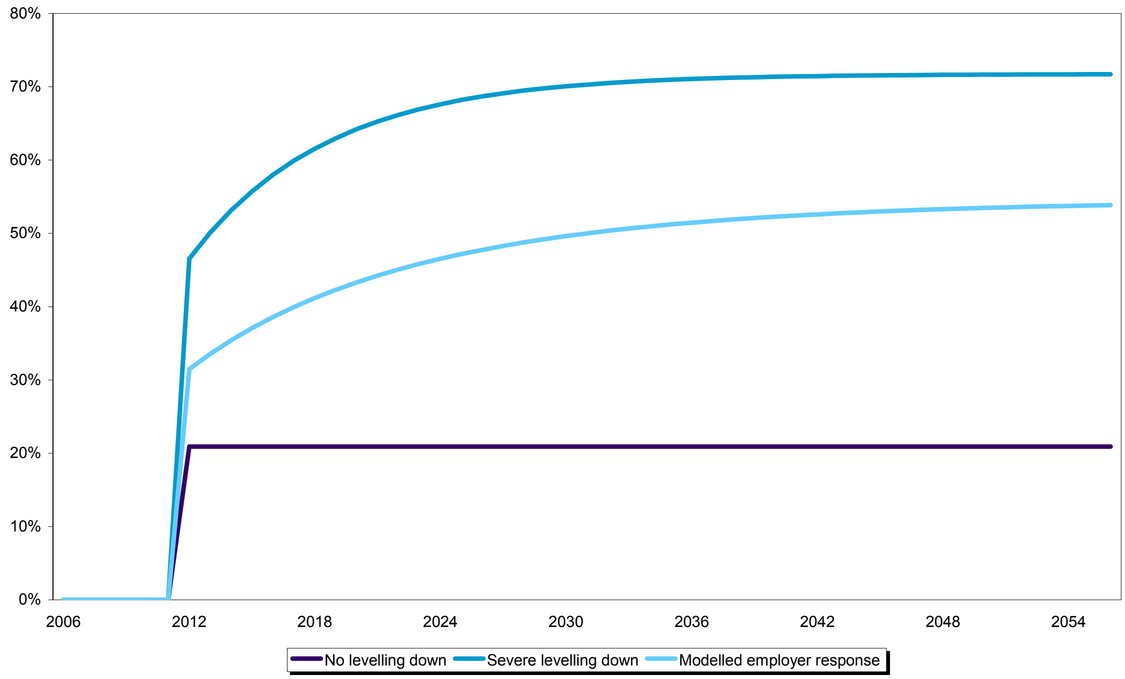
Figure 2: DB membership – outcomes compared



This analysis also highlights the danger that future pension saving could be concentrated in the new, unproven, part of the pensions system. Ministers have said they want Personal Accounts to complement existing provision, rather than replace the good schemes that already exist[13]. If employers react as the modelled employer response prepared by Deloitte suggests they may, nearly four out of ten private sector employees saving for a pension could be in Personal Accounts by 2016 and nearly half could be in this position by 2026. Without levelling down, the Personal Accounts system would serve around one-fifth of private sector savers, but this would increase to around 70% under the 'severe levelling down' scenario.

[13] E.g., John Hutton, speech to ABI Saver Summit, 23 November 2006.

Figure 3: Proportion of active members in Personal Accounts – outcomes compared



Pension Contributions

Employer contributions

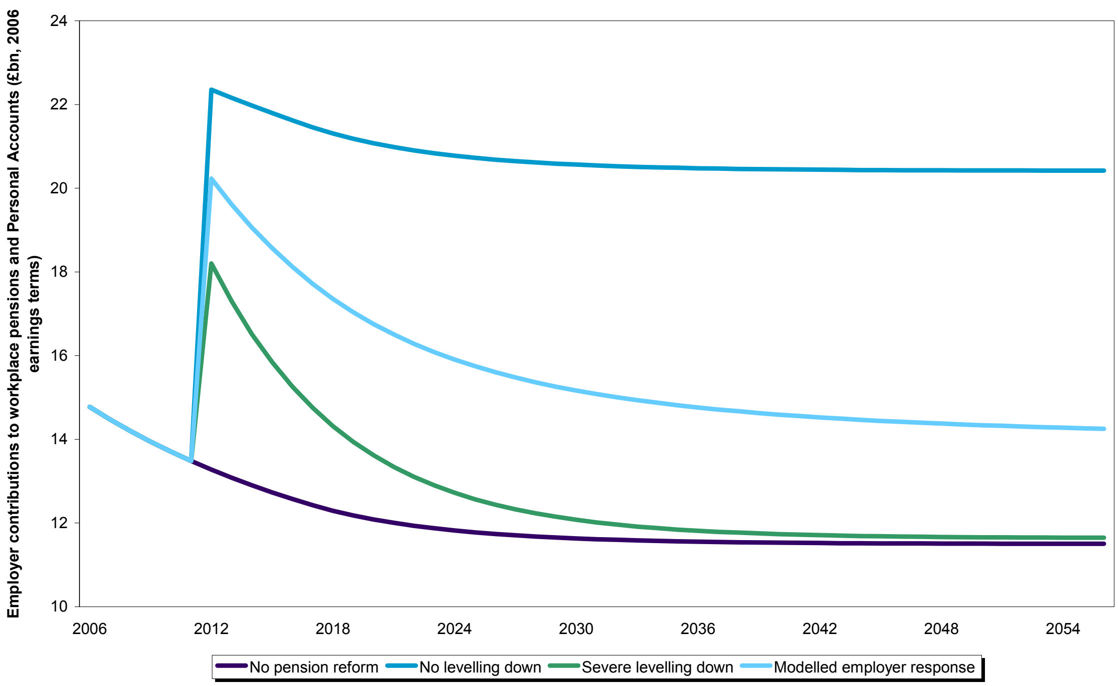
Unless there is severe levelling down, the analysis suggests that the value of employer contributions is likely to increase in the long term as a result of the 2012 reforms. However, there is a lot to play for. By 2016, employer contributions could be £3.5 billion higher (in today's earnings terms) without levelling down than if employers react in line with the 'modelled employer response' scenario; by 2026, they would be £5 billion higher – an increase of one-third; and in the long run, they would stabilise at a level that is 43% higher than under the 'modelled employer response'.

Even in the 'severe levelling down' scenario, employer contributions are shown to be higher in the short term as a result of pension reform. This is because the scenario protects existing scheme members from the effects of levelling down for as long as they remain with the same employer. This boost to employer contributions disappears once staff turnover has enabled the effects of levelling down to work through the system. In a steady state, the aggregate level of contributions paid by private sector employers would be no higher than without pension reform. Instead, these contributions would simply be divided between more people. The extra employer contributions flowing to those who would not save without pension reform would be entirely offset by a reduction in employer contributions for those who would have saved anyway.

Table 1: Employer contributions – outcomes compared

	Employer contributions (£bn, 2006 earnings terms)				
	2006	2012	2016	2026	2056
No pension reform	14.8	13.3	12.6	11.7	11.5
No levelling down	14.8	22.4	21.6	20.7	20.4
Modelled employer response	14.8	20.2	18.1	15.6	14.3
Severe levelling down	14.8	18.2	15.3	12.4	11.6

Figure 4: Employer contributions – outcomes compared



In each of the scenarios analysed, the aggregate value of employee contributions is higher than it would be without the 2012 reforms. This is because millions of non-savers find themselves contributing for the first time, whereas levelling down is assumed to have only a small impact on employee contribution rates[14]. Even in the 'severe levelling down' scenario, the total value of pension contributions (taking employer contributions and employee contributions together) is therefore shown to increase.

However, our analysis again shows significant variations depending on how employers react to pension reform. The cumulative value of all contributions made between 2012 and 2056 would be £240 billion higher (in today's earnings terms) if no employers level down than if employers react as the 'modelled employer response' suggests they may.

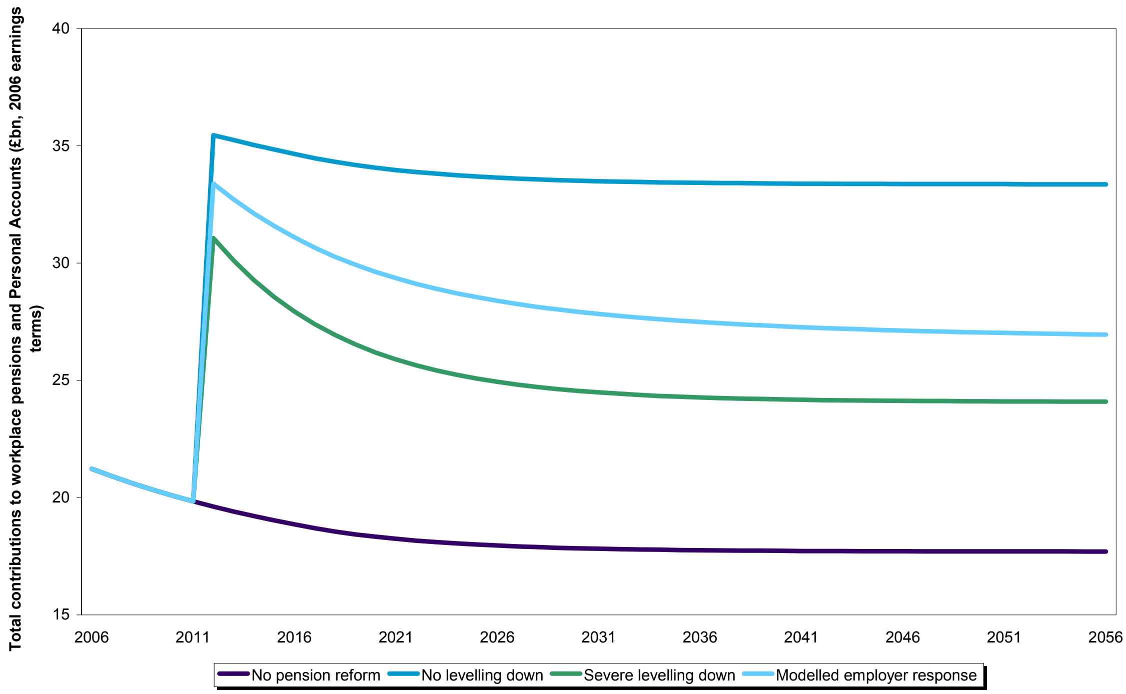
[14] In practice, some employees may choose to compensate for lower employer contributions by increasing the amount they save themselves. We did not attempt to model for this. The analysis may also understate employee contributions to Personal Accounts owing to the salary assumptions used (see Annex 2).

Comparing what happens with no levelling down with what happens under the 'severe levelling down' scenario, the difference is £380 billion.

Table 2: Total contributions – outcomes compared

	Total contributions (£ billion, 2006 earnings terms)			
	2006	**2012**	**2026**	**2056**
No pension reform	21.2	19.6	18.0	17.7
No levelling down	21.2	35.5	33.6	33.4
Modelled employer response	21.2	33.4	28.4	26.9
Severe levelling down	21.2	31.0	24.9	24.1

Figure 5: Total contributions – outcomes compared



4. Impact on people who would save in a workplace pension without reform

There is little question that the 2012 reform package should improve retirement income from funded saving for people who otherwise would not have access to a workplace pension and for people who would not choose to join unless they were auto-enrolled.

Our analysis suggests, however, that if there is a severe reaction from employers, pension reform will simply spread employer contributions more thinly. Some policymakers may conclude that this distribution of employer contributions will be an improvement on the one we have today. Even so, the losers from this redistribution cannot simply be ignored.

Without reform, people who would save anyway are projected to receive employer contributions averaging 8.3% in 2012, falling to 7.3% in 2026. The results would be the same if levelling down can be avoided. With levelling down, however, this fall is much more pronounced, as shown in Table 3.

Table 3: Average employer contribution rates for people who would save in workplace schemes without reform

	2016	2026	2056
No pension reform / no levelling down	7.8%	7.3%	7.1%
Modelled employer response	6.9%	5.5%	4.9%
Severe levelling down	6.6%	5.0%	4.5%

The figures in table 3 show average contributions rates for everyone who would have saved in a workplace scheme without pension reform – including those whose employers choose not to level down. The impact on individuals who are affected by levelling down will be more pronounced.

Many of those losing out would be middle earners. Employers responding to Deloitte's survey reported that the salaries of existing pension scheme members averaged approximately £25,000. This is broadly in line with average earnings in the economy as a whole[15]. Thus, it is millions of ordinary hardworking families, not just a small number of senior executives, who would suffer the consequences of levelling down.

[15] At April 2006, median full-time earnings for adults in the private sector were a little under £23,000. Mean full-time earnings were a little over £30,252 (*Annual Survey of Hours and Earnings 2006*).

Box 3: Effect of levelling down on moderate earners[16]

Phil earns £23,000. Each year, his salary rises in line with average earnings. He will save for 40 years continuously.

Without levelling down, his employers would all offer DC schemes with a 6% employer contribution and a 3% employee contribution based on gross earnings. This would produce a pension pot worth £221,000 at retirement. Of this, £147,300 would derive from employer contributions. Phil can convert this money into an annuity worth £10,370 a year, of which £6,910 derives from employer contributions.

If Phil's employers level down, he will only have access to Personal Accounts with the minimum rate of employer contributions. Although his own contributions will be higher (at 5% of banded earnings), his final pension pot will be £153,400 – 30% less than he would have got without levelling down. Of this, £57,500 comes from employer contributions. Phil can convert this money into an annual income of £7,280, of which £2,730 derives from employer contributions.

So, despite saving more himself, Phil's pension will be worth 30% less if his employers level down. This will leave him around £3,000 a year poorer.

Charlotte earns £20,000. Each year, her salary rises in line with average earnings. She is 20 years from retirement and is about to start saving for the first time.

Without levelling down, Charlotte's employers would provide a contracted-in final salary scheme. This would provide 1/80th of her final pensionable earnings for each year of service. The scheme defines pensionable pay as excluding the first £5,000, increasing this with price inflation each year. After 20 years' service, Charlotte would qualify for annual pension payments of £6,030.

If Charlotte's employer levels down to the minimum level of contributions in Personal Accounts, she will retire with a pension pot of £38,900, of which £14,600 derives from employer contributions. She can convert this into an annual income of £1,640, of which £620 derives from employer contributions.

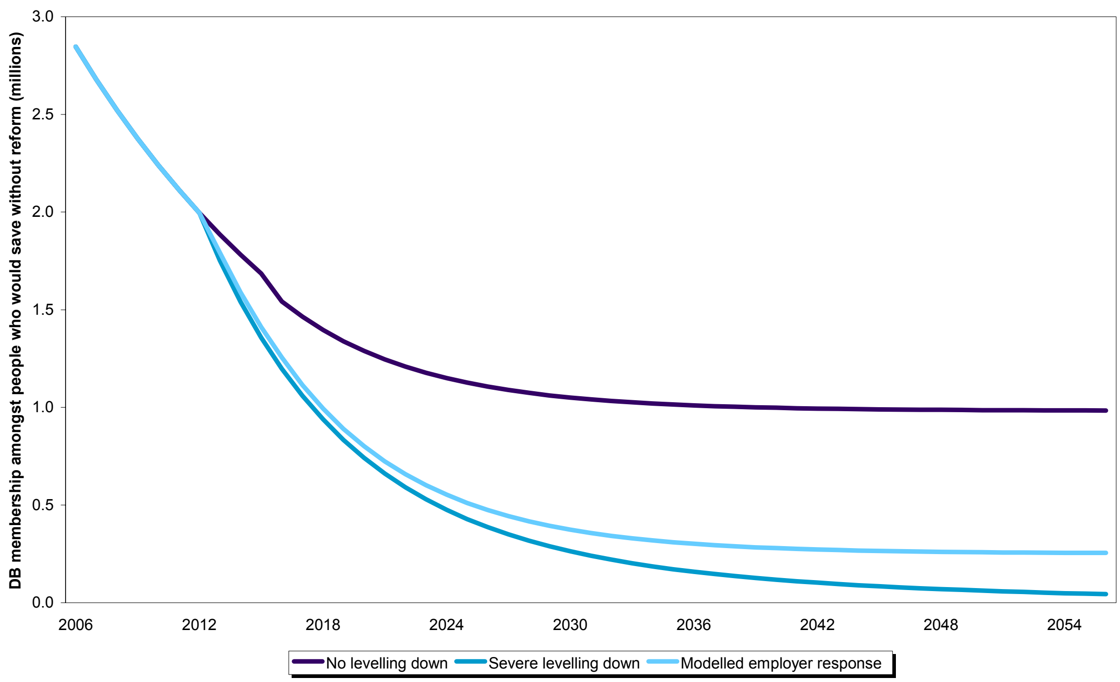
So if Charlotte's employer levels down, her pension will be worth 70% less. This will leave her £4,390 a year poorer.

[16] All figures are in today's prices. Earnings are assumed to rise by 2% in real terms each year. This causes DC contributions to rise and DB pensions to become more valuable. For simplicity, it is assumed that pension reform is introduced immediately (this is equivalent to ignoring earnings growth between now and 2012). In all cases, DC pensions are assumed to produce a 3.5% real rate of return each year. Annuity rates are gender-specific rates available to 65 year-old non-smokers retiring in September 2006. All annuities are single life, rise in line with RPI inflation, and have no guarantee. Annual Management Charges in both Personal Accounts and existing DC schemes are assumed to by 0.5%. Numbers have been rounded.

Our analysis indicates that, by 2016, 0.7 million people who would have saved in workplace schemes without pension reform could instead be saving in Personal Accounts at the minimum contribution levels. This rises to 1.6 million by 2026 and some 2.5 million in the long run.

By 2026 around 0.6 million people who would have been saving in DB schemes without pension reform could find this option closed off if employers react in line with the 'modelled employer response'.

Figure 6: Private sector DB membership amongst people who would in workplace schemes without reform



Of course, without pension reform, some people would move between jobs with pensions and jobs without pensions. For such people, the effects of levelling down may be less pronounced than the above analysis implies. In that case, however, more individuals would be affected.

5. Detailed results

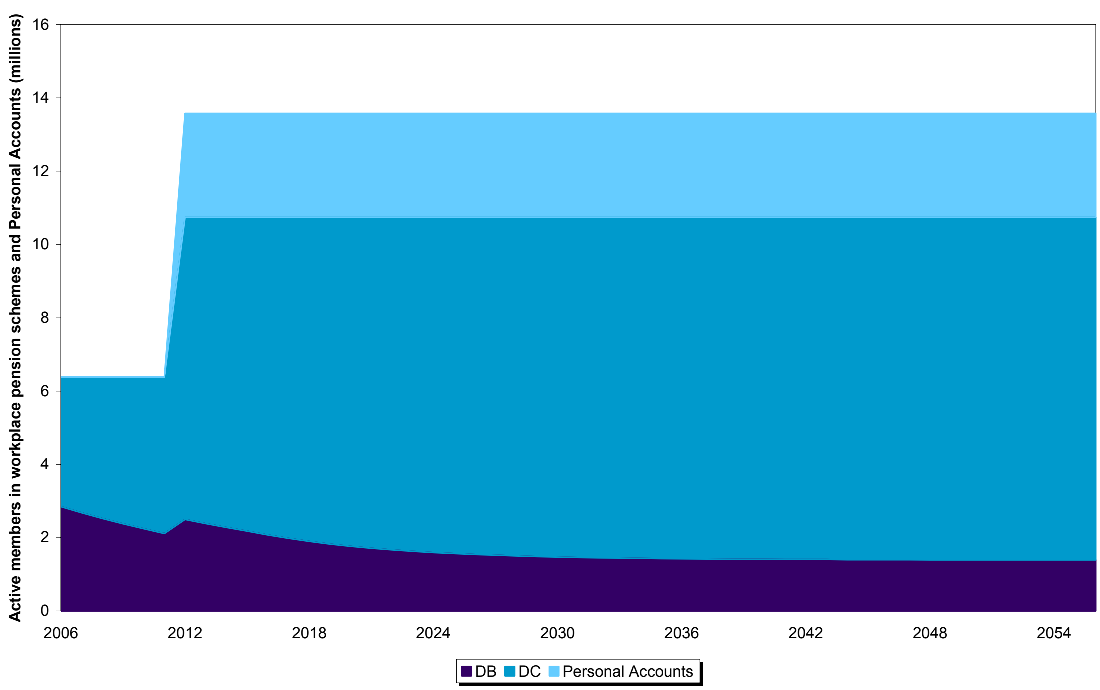
'No levelling down'

This scenario shows how pension reform will have an unambiguously positive effect if employers with good schemes choose to offer the same type of pension and contributions under auto-enrolment as they would have offered in an opt-in environment. It takes account of ongoing trends in pension provision but looks at what might happen if pension reform does not itself cause further levelling down. It is assumed that, from 2012, employers auto-enrol staff into the scheme they would have made available on an opt-in basis without pension reform and that two-thirds of those auto-enrolled do not opt out.

Membership

In this scenario, membership of workplace schemes, excluding Personal Accounts, is 4.4 million higher in 2012 and subsequent years than it is shown to be without pension reform. By 2026, it is 3.6 million higher than under the 'modelled employer response'. There is still a decline in DB membership, as schemes that have already closed to new members continue to shed staff and those that would have closed without pension reform still close. However, membership of DB schemes is twice as high in 2026 as it would be if employers respond in line with the 'modelled employer response'.

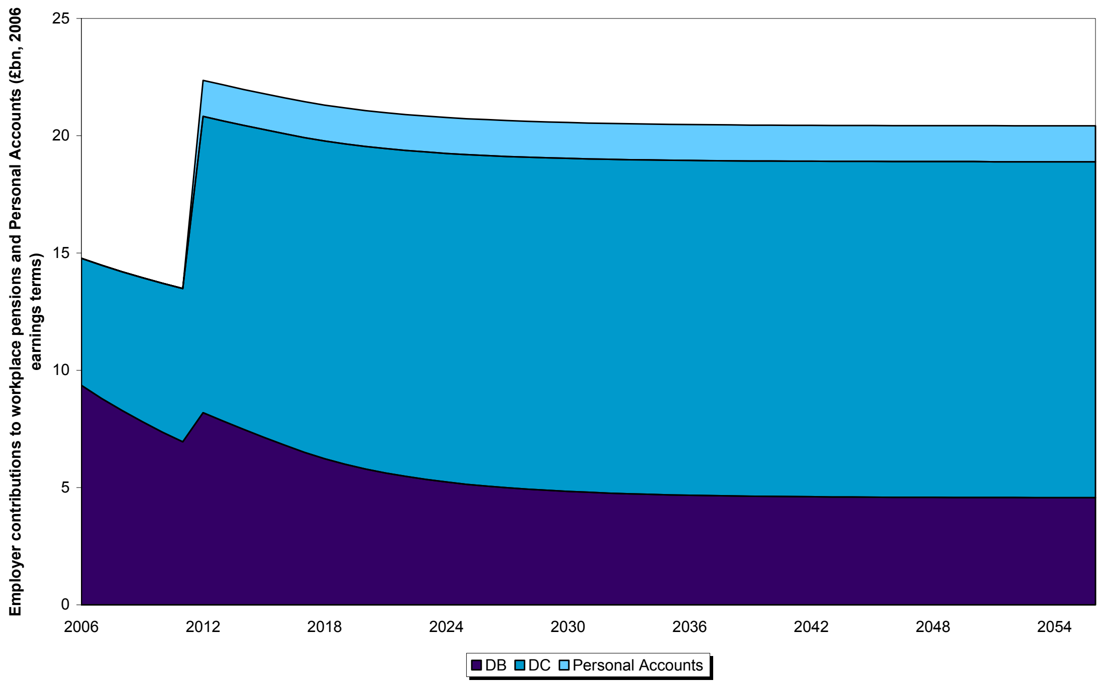
Figure 7: Pension scheme membership – no levelling down



Contributions

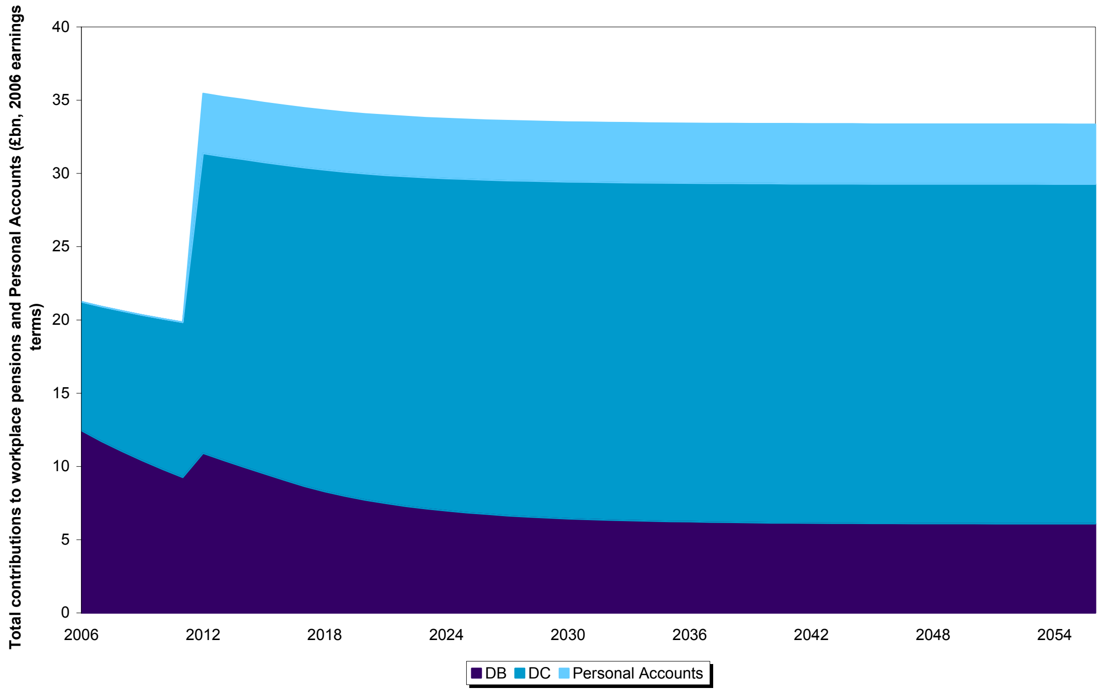
From 2012, employer contributions are £9 billion higher (in 2006 earnings terms) in this scenario than without pension reform. By 2016, they are £3.5 billion higher than under the 'modelled employer response'. By 2026, this gap has widened to £5 billion.

Figure 8: Employer contributions with no levelling down



The effect of auto-enrolment on participation means that the annual long-run value of employee contributions is twice as high under this scenario as without pension reform. The absolute increase in the total value of contributions compared with the 'modelled employer response' is therefore similar to the increase in the value of employer contributions.

Figure 9: Total contributions – no levelling down



Average employer contribution rates for all members are lower in the long run than they would be without pension reform (6.1% as opposed to 7.1%). This is because those people who would not have access to an employer scheme without pension reform are auto-enrolled with an employer contribution of 3% of banded earnings, reducing the average.

'Severe levelling down'

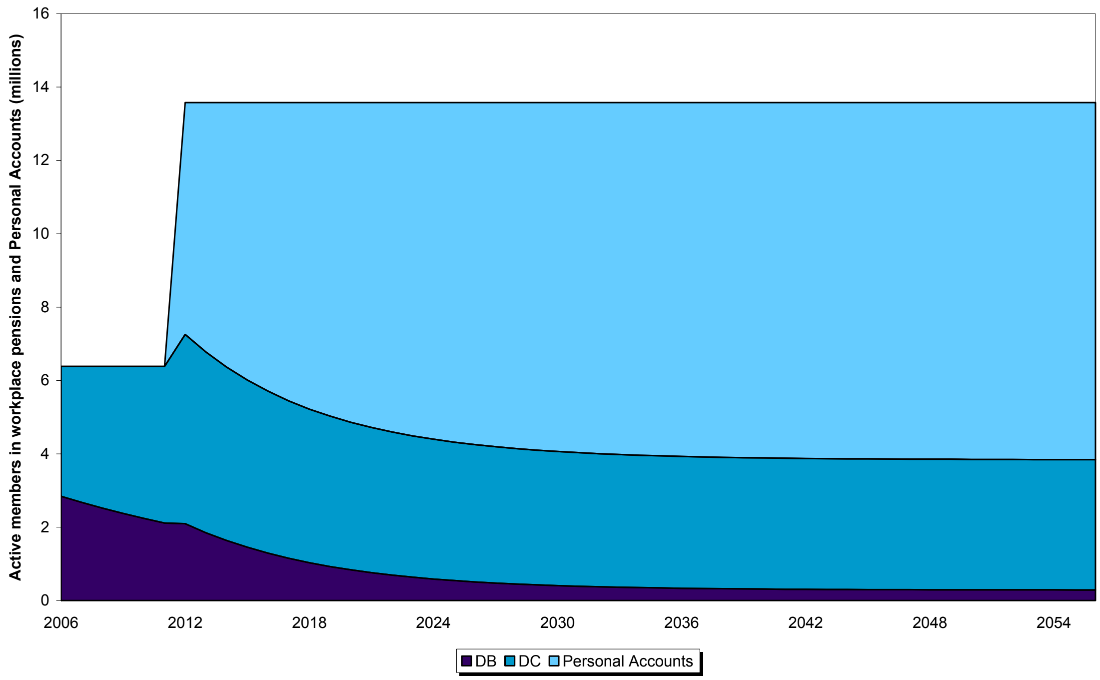
In this scenario, only 20% of employers with existing schemes auto-enrol staff into these schemes on today's terms. The remaining 80% close their schemes to new members. Employees eligible for auto-enrolment who have not joined the scheme by 2012 are auto-enrolled into Personal Accounts at minimum contribution levels. Existing members can continue accruing pension rights on existing terms.

Under these assumptions, DB membership falls to just 300,000 by 2056. Most of this decline takes place within a decade of the reforms. By 2020, there are nearly twice as many people saving in Personal Accounts as there are saving in workplace DB and DC schemes put together.

If employers react in anything like this way, the Government will have failed to ensure that Personal Accounts complement existing provision rather than replacing it. Personal

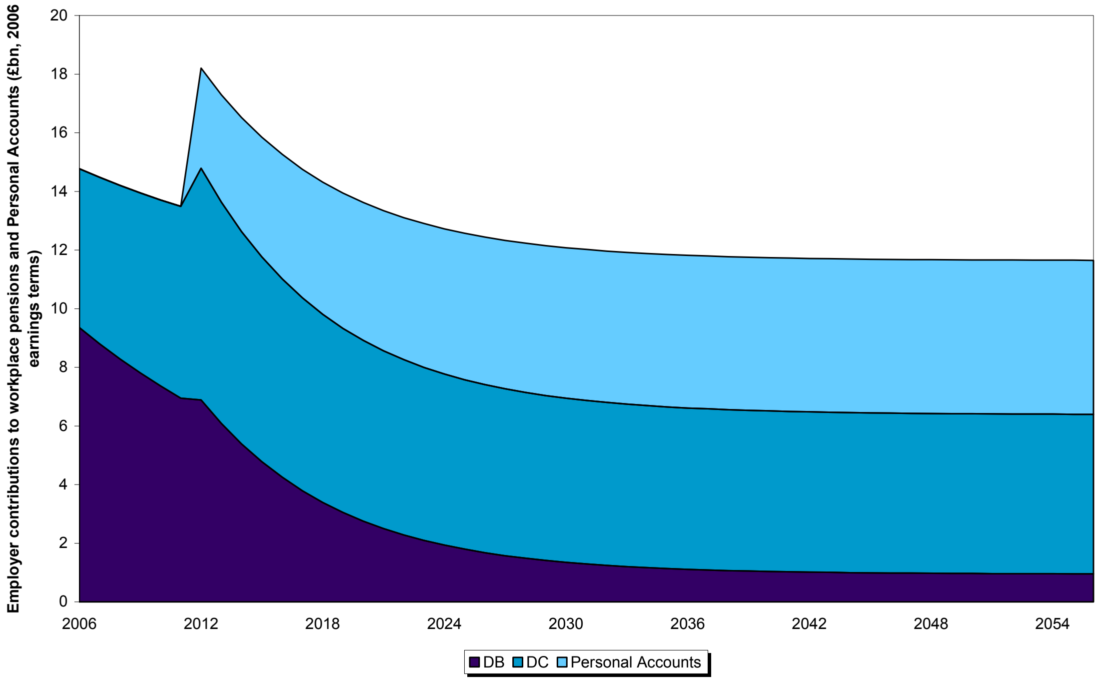
Accounts would dominate UK pension provision and the board of any National Pension Savings Scheme would have very significant power in the investment market.

Figure 10: Membership – severe levelling down



Initially, auto-enrolment means that the total value of employer contributions under this scenario is more than one-third higher than with no pension reform. However, this effect falls away rapidly. In the long run, total employer contributions are just 1% higher than with no pension reform – despite the fact that these contributions are spread over twice as many people.

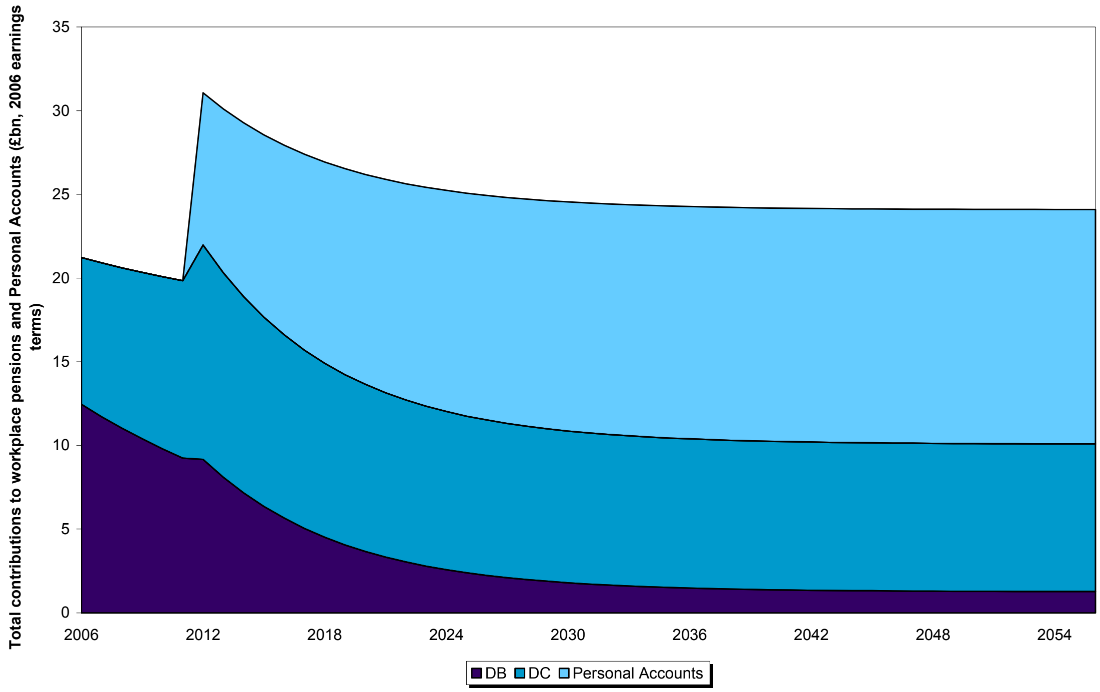
Figure 11: Employer contributions – severe levelling down



Taking employer and employee contributions together, the total amount paid into pensions is still higher than it would be without pension reform, since millions of people are paying contributions for the first time.

However, contributions are heavily concentrated in Personal Accounts, which receive 58% of contributions once change has worked through the system. The long-run level of contributions to existing workplace schemes is projected to be 43% lower than it would be without pension reform.

Figure 12: Total contributions – severe levelling down



'Modelled employer response'

In the 'no levelling down' and 'severe levelling down' scenarios, employers either auto-enrol everyone into their existing scheme or close it to new members and substitute Personal Accounts at the minimum contribution rate. In practice, some employers may look for a middle way between these extremes. In this scenario, some employers reduce contribution rates (either by changing the rules of an existing scheme, or by setting up a new scheme) without lowering them all the way to the Personal Accounts minimum.

Based on work they had undertaken for clients in the insurance sector, Deloitte allocated employers to different boxes depending in how they are assumed to respond to pension reform. This allocation is based on a combination of survey responses and other information held by Deloitte (covering firms' trading and recruitment expectations, their attitude to the provision of benefits, the cost of auto-enrolment into their existing scheme and the profile of their workforce). The new dimension in Deloitte's work for the NAPF is that these reactions were mapped on top of a projection indicating how pension provision might change without reform (described in Annex 1). This meant assuming that some further levelling down would occur even without pension reform – both before and after 2012.

The five basic employer reactions are described below, but employer reactions will not be perfectly homogeneous within each category. For example, some employers in the 'shrink and maintain' category will reduce contributions all the way down to the Personal

Accounts minimum, whereas others will reduce contributions only to the midpoint between the existing contribution rate and this minimum.

- **Open and grow:** Employers keep their scheme open for all new recruits, applying auto-enrolment to the existing scheme on existing terms.

- **Open and reduce:** Employers keep their schemes open for all new recruits. Contribution rates and accrual formulae are reduced for new and existing members. New contribution rates are halfway between existing rates and the minimum contributions in Personal Accounts.

- **Limit and maintain:** Employers change eligibility rules so that only senior managers are able to join the existing scheme on existing terms. The remainder of those eligible for auto-enrolment are auto-enrolled either into a new workplace scheme or into Personal Accounts, sometimes at the minimum contribution rate and sometimes at the mid-point between this and the existing contribution rate. Individuals who already belong to existing schemes can continue accruing new pension rights on existing terms until they leave the company.

- **Shrink and maintain:** Employers close their schemes to new members but maintain contribution rates and accrual formulae for existing members. New recruits and existing employees outside the scheme are auto-enrolled either into Personal Accounts or into a new DC scheme. Some are auto-enrolled at the minimum contribution rate. Others are auto-enrolled at the midpoint between this and the existing contribution rate.

- **Shrink and reduce:** Employers close their schemes to new members and to future accruals. All eligible staff are auto-enrolled either into a new DC scheme or into Personal Accounts. Some are auto-enrolled at the minimum contribution rate. Others are auto-enrolled at the midpoint between this and the existing contribution rate.

Employers with existing schemes are distributed between these categories as follows:

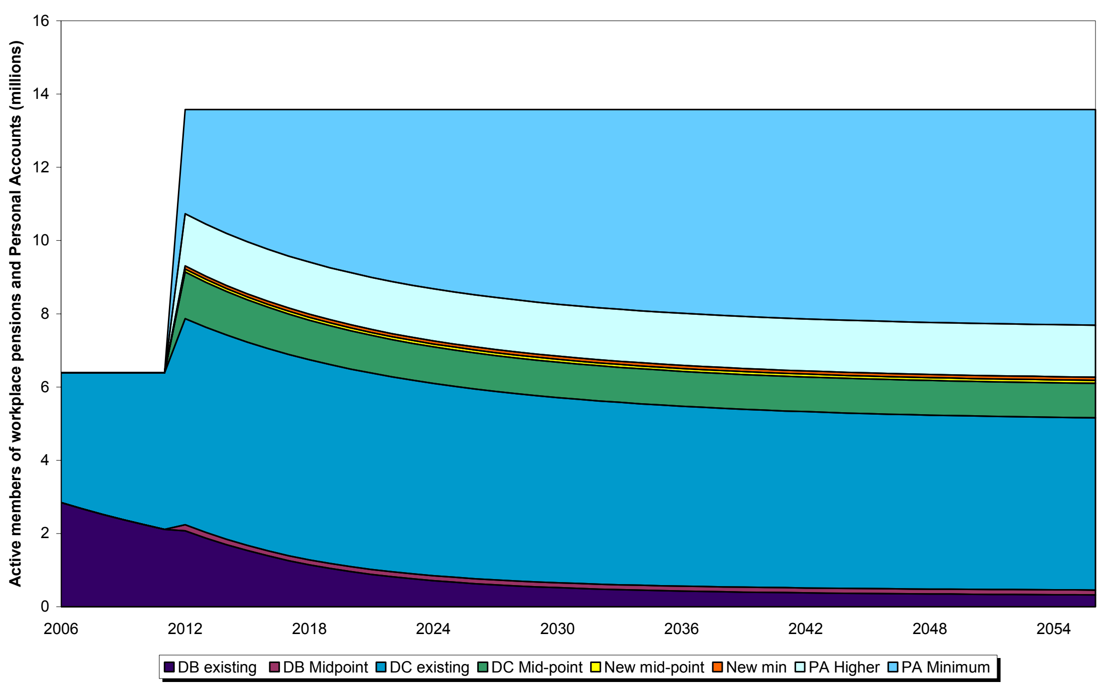
Table 4: Employer reactions – modelled employer response

	DB schemes		DC schemes	
	% Schemes	% 2012 members	% Schemes	% 2012 members
Open & Grow	14%	12%	23%	31%
Open & Reduce	9%	8%	8%	11%
Limit & Maintain	22%	19%	35%	37%
Shrink & Maintain[17]	55%	61%	29%	13%
Shrink & Reduce	0%	0%	4%	8%

Membership

By 2026, almost half of private sector employees saving for a pension are projected to be saving in Personal Accounts. DB membership in 2026 is half its 2012 level and 350,000 lower than without pension reform.

Figure 13: membership – modelled employer response



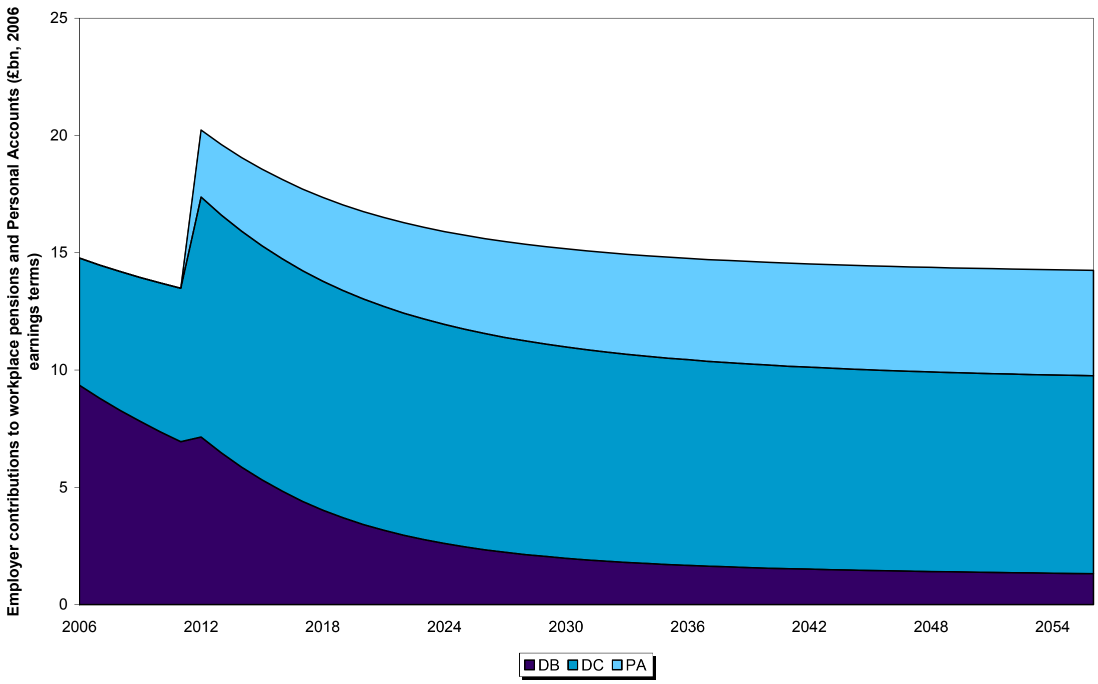
Contributions

If employers reacted in this way, employer contributions would be 52% higher in 2012 than with no pension reform. As the effects of levelling down start to work through, this comparison becomes less favourable. Compared with what is projected to happen in

[17] Defined benefit schemes which have already closed to new members, or which are assumed to do so before 2012, are included in this row. In most cases, the employers concerned will have open DB schemes which feature elsewhere in the table.

the absence of pension reform, employer contributions are projected to be 44% higher in 2016, 33% higher in 2026 and 24% higher in the long term.

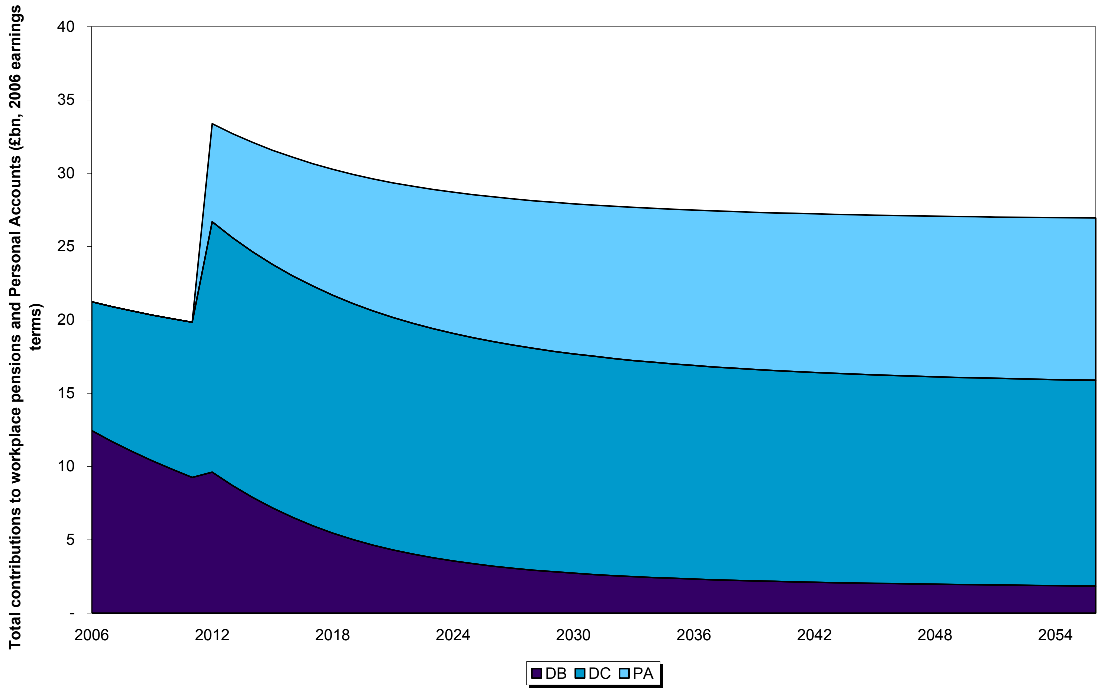
Figure 14: Employer contributions – modelled employer response



The effect on contributions is more pronounced when we look at total contributions, including those paid by employees. This is because the effect of auto-enrolment on employee contributions is almost entirely positive, creating more savers without having a significant impact on the amount contributed by existing savers.

In 2016, total contributions are projected to be 65% higher than without pension reform. This drops to 58% by 2026 and 52% in the long run.

Figure 15: Total contributions – modelled employer response



Conclusion

It seems certain that the Government's pension reforms will increase the number of people saving for retirement. However, it is less clear by how much the level of savings will alter. While this report suggests that the level of savings is likely to increase, the amount saved each year may be higher or lower depending on the way in which the new system of Personal Accounts is introduced.

According to our analysis, if the reforms manage to avoid levelling down – that is to say, if employers offering good schemes auto-enrol all their employees into those schemes on the standard terms and not at the Personal Accounts minimum – annual pension contributions will be around £34 billion by 2026. But if employers react as Deloitte's Pension Reform in the Workplace model suggests they may, the total value of savings may be £6 billion lower than this. And if there is severe levelling down, it may be £9 billion lower.

If levelling down occurs, the impact will be felt most keenly by those ordinary working people who would have been in a workplace pension even without pension reform. The modelling for this report indicates that this group of pension savers may, over time, lose out on employer contributions amounting to 2% of earnings. Separate NAPF analysis suggests that someone on median earnings can expect to be about £3,000 a year better off in retirement after a lifetime of saving in one of today's typical DC pensions than they would be after a lifetime saving in Personal Accounts.

The way in which the reforms are implemented will not only affect the amount of pension saving but also the nature of future pension provision. If employers offering a pension opt to place all their employees into their own pension arrangements, Personal Accounts will, as the Government intends, be a 'targeted intervention', serving around 20% of the private sector employees who save for retirement in future. However, if employers react as the model suggests they may, a majority of private sector employees saving through the workplace will eventually be in Personal Accounts.

Clearly, the main lesson from this report is that employer reactions to Personal Accounts will be a key factor determining how successful the overall package of pension reform will be. While pension reform presents the threat of levelling down it also presents the opportunity of extending today's good workplace pensions to cover far more people.

The NAPF believes pension reform can lead to this positive outcome if the Government:

- Designs Personal Accounts to meet the needs of the target group – those that do not have access to a workplace pension with an employer contribution – and adopts a simple, flexible, test for assessing when an existing scheme is a suitable alternative to Personal Accounts;

- Places a formal duty on the Delivery Authority for Personal Accounts to take account of the impact of the new regime on existing provision, both in its recommendations for the design of Personal Accounts and on any other matters on which it provides advice to Ministers;

- Provides support for existing provision through fiscal measures that ease the cost pressures faced by employers who auto-enrol all staff into schemes with employer contributions worth significantly more than the minimum; and

- Backs the NAPF's proposed Good Pensions Mark which is designed to help employers demonstrate the value of the pension on offer to current and prospective employees.

There is no doubt that some employers will respond to the 2012 reforms by altering their pension provision. However, widespread levelling down need not be inevitable. If the Government acts to support today's high-value workplace pensions, levelling down can be the exception rather than the rule.

Annex 1: The 'counterfactual' – trends in pension provision without pension reform

Before modelling the impact of pension reform, NAPF asked Deloitte to create a counterfactual showing what the pensions landscape might look like without reform[18]. There are a number of reasons why it is unclear what this 'counterfactual' would be:

- As the Chairman of the Pensions Regulator, David Norgrove, has observed, "pensions are a data-free zone"[19]. Different data sources point to different conclusions about the number of people saving in private sector workplace pensions today and the value of these schemes. Moreover, the Government says it does not have data on the type of pension provision currently being taken up by new recruits[20].

- Many employers have closed their defined benefit schemes to new members while allowing existing members to continue accruing benefits until they leave the company. Even if employers make no further changes to their pension provision, the number of members in defined benefit schemes will therefore shrink as existing members leave closed schemes and are replaced by employees in defined contribution schemes. However, there are no official projections of how quickly this shift will take place.

- Some employers who have not yet closed their defined benefit schemes to new members will do so in future. While few companies have so far closed their DB schemes to future accruals, others may yet do so. Again, we do not know how many such closures there will be, how quickly they will take place, or precisely what sort of pensions employers will establish in their place.

- There is no comprehensive data about the value of employer contributions to different sorts of schemes. Since the data that exists is collected through surveys, reported contribution rates will not be strictly comparable where employers define pensionable earnings differently. Treatment of contracted-out rebates and deficit-correcting contributions to defined benefit schemes may introduce further distortions.

Faced with this uncertainty, we chose to make a number of assumptions. If our counterfactual overstates the level of private sector provision in the absence of pension reform, it will overstate the gains from avoiding levelling down. If it understates this level of provision, it will understate the gains from avoiding levelling down.

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[18] The DWP commissioned CRA International to suggest what this "counterfactual" might look like. This work has not been published (*Hansard*, 8 November 2006, col.1642w).
[19] Oral evidence to Work and Pensions Select Committee, 22 March 2006.
[20] *Hansard*, 9 October 2006, col.24w

How many people are in private sector schemes…

To estimate current membership of workplace pensions amongst private sector employees, we asked Deloitte to take the midpoint between their own data and the more upbeat *Annual Survey of Hours and Earnings* (*ASHE*). The table shows that our estimate of the number of private sector employees saving in workplace pensions appears reasonable when viewed in the context of other published sources[21].

Table 5: Active membership in private sector workplace schemes today

	Defined Benefit	Defined Contribution	Total
Deloitte survey and extrapolation	2.2 million	2.9 million	5.1 million
Annual Survey of Hours and Earnings (ONS)	3.5 million	4.1 million	7.6 million
Employer Pension Provision Survey (DWP)	2.4 million	3.5 million	6.0 million
Occupational Pension Schemes Survey (GAD)	3.7 million	n/a	n/a
State of the Nation's Savings (ABI/YouGov)	3.0 million	4.7 million	7.7 million
Our baseline	**2.8 million**	**3.5 million**	**6.4 million**

[21] The Annual Survey of Earnings and Hours and Employers' Pension Provision Survey both show membership of different types of schemes as a percentage of private sector employees. The numbers in the table assume that there are 18.6 million private sector employees (the figure used in the White Paper). The ABI/YouGov figure has been calculated on a slightly different basis and is not strictly comparable.

The ASHE 'defined contribution' figure was derived by summing the 'defined contribution', 'group personal pension', 'stakeholder pension' and 'unknown type of provision' categories from published data.

Deloitte's figures exclude pension provision from firms with fewer than five employees.

None of these figures should be seen as precise estimates. We can illustrate the range of uncertainty involved through reference to the GAD survey. The GAD's central estimate is that there were 4.68 active members of trust-based schemes (both DB and DC) in April 2005. The department explains, however, that this means there is a 95% chance that the figure is somewhere between 4.17 million and 5.20 million.

Fieldwork for the ASHE, the EPP and the GAD survey was undertaken in 2005. The table takes no account of further changes that may have taken place since then.

Figures include members of existing schemes where employer contributions are currently worth less than the Personal Accounts minimum.

…and what these schemes are worth

Deloitte assumed that the average employer contribution rate in DB schemes is 13.5%, excluding special contributions designed to eradicate pension scheme deficits. This is the midpoint between Deloitte's own survey finding (11%) and the GAD's estimate (16%).

The average employee contribution to DB schemes is assumed to be 4.5%. The average contribution to DC schemes is assumed to be 6% from the employer and 3.7% from the employee. Here, Deloitte's findings are similar to those from other surveys[22].

In order to calculate how much these contributions are worth at an aggregate level, it is assumed that these contribution rates apply to gross basic pay. No adjustment has been made to reflect the value of contracted-out rebates.

The evolution of the pensions landscape

Before estimating how this picture would change in future, with or without pension reform, we made a number of simplifying assumptions:

- The number of private sector employees remains fixed at 18.6 million. The age and income profile of the workforce does not change.
- We assume that there are no changes to the industrial composition of the UK economy or the staffing levels of individual firms and therefore no effect on levels of pension provision.
- The ongoing shift away from defined benefit provision will affect only the type of workplace pensions on offer and not the number of people saving in workplace pensions (even though the incentive to save will be weakened for those affected).

Implicit in this analysis is the further assumption that employees' propensities to save in pensions are not altered by attitudinal changes, by changing levels of financial education, or by changes to the State Pension system.

Using the latest GAD survey, we assumed that 58% of active members in DB schemes belong to schemes that are still open to new members[23]. Based on the experience of insurance clients who operate insured schemes, Deloitte then assumed that on average 14% of members leave their employer (and therefore these closed schemes) each year.

[22] Deloitte's data excludes schemes where the employer contribution rate is zero. One problem with survey data on pension contributions is that different respondents may have different pensionable pay definitions. In order to calculate the cash value of pension contributions in different scenarios, Deloitte assumed that contribution rates were expressed as a percentage of gross salary and made no adjustment for contracted out rebates.

[23] The EPP suggests a similar division between members of open schemes (62%) and members of closed schemes.

Some companies that still have DB schemes open to new members today will close them in future. We assume that today's open DB schemes close at a rate of 5% a year until 2016. Schemes still open in 2016 are assumed to remain open indefinitely. No closures to future accruals are assumed and the total number of active members in workplace schemes is assumed to remain unchanged in the absence of pension reform.

Together, these assumptions have the effect of reducing private sector DB membership to a little under one million in the long run – around one third of its current level . This is broadly in line with the Pensions Commission's conclusions. In its *First Report*, the Commission assumed that "active membership of private sector DB schemes will ultimately fall by 60% from the 2000 level. This would imply a long-term floor of perhaps 1.6-1.8 million active members"[24]. By the time of its *Second Report*, the Commission continued to model on this basis, but believed that "a much lower figure now looks likely"[25].

When modelling future entitlement to Pension Credit, the DWP assumed that the DB to DC shift would stabilise when 30% of new entrants to private sector schemes have access to DB pensions[26]. In that case, DB provision in the absence of pension reform would be twice the level assumed in this note. The risks associated with levelling down, and the gains from averting it, would then be greater than this report implies.

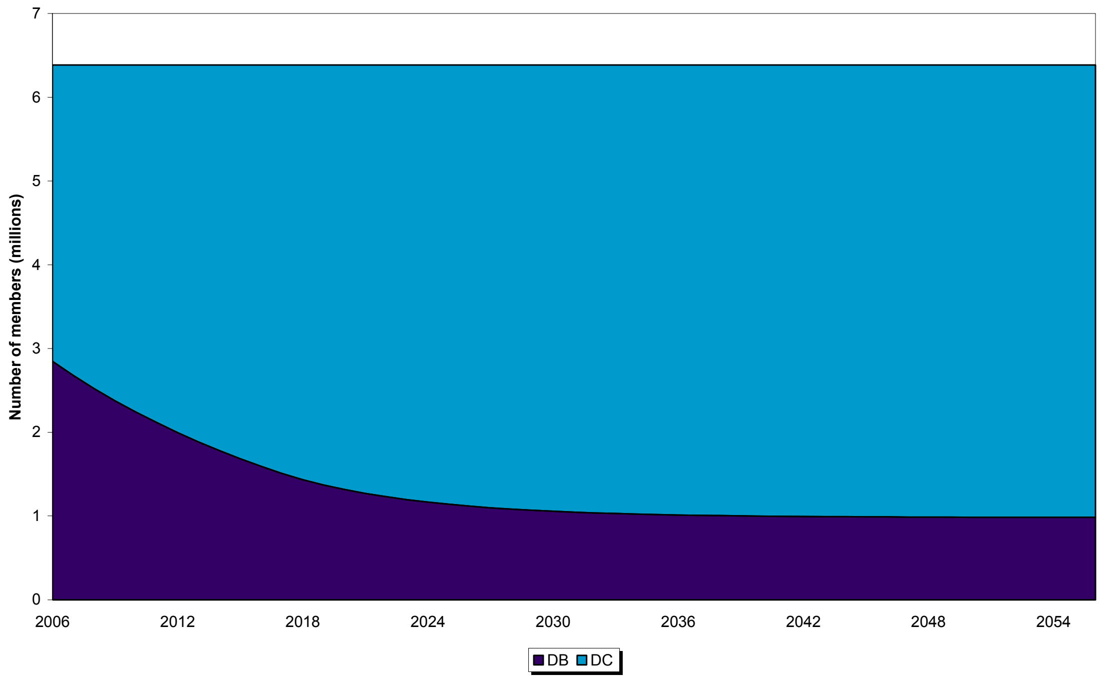
Where DB schemes have closed or close in future, it is assumed that average DC schemes are offered in their place.

Pension scheme membership without pension reform

Under these assumptions, the number of active members of private sector DB schemes is projected to fall by 30% by 2012, 50% by 2018, and 65% by 2037. There would be a corresponding rise in DC membership.

[24] *First Report*, p85
[25] *Second Report*, p48
[26] Annex 1, *Projections of Pension Credit Entitlement*, DWP, November 2006

Figure 16: Active members – no pension reform

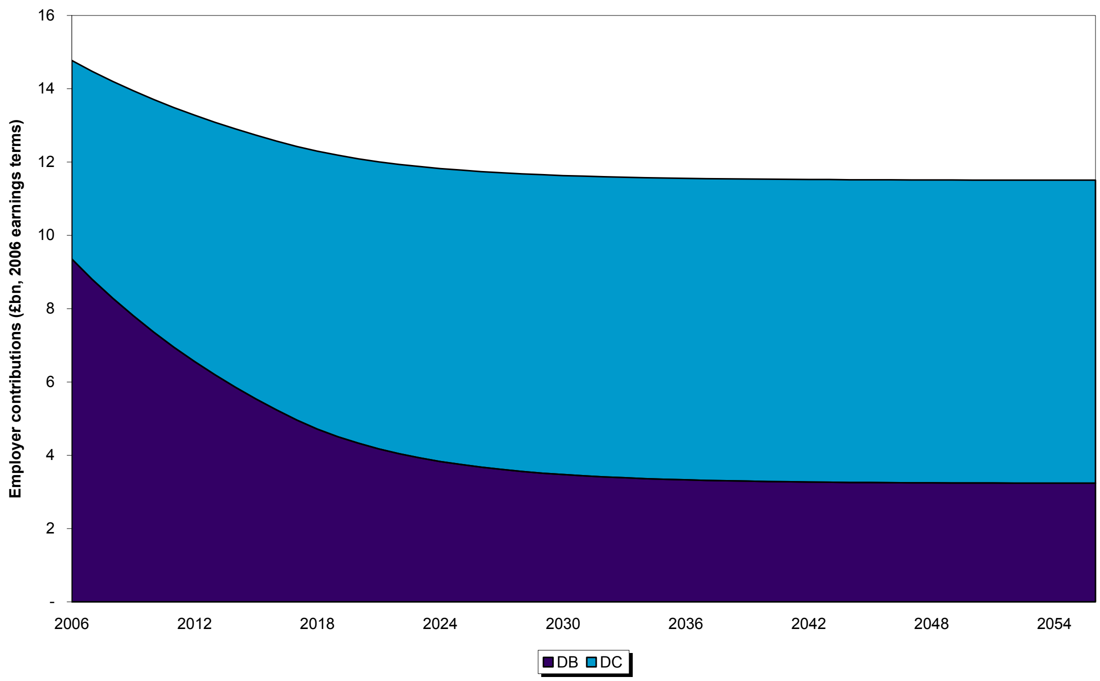


Contributions

The model works by shifting individuals from defined benefit schemes with average contribution rates to defined contribution schemes with average contribution rates. This means the fall in employer contributions to DB schemes, expressed in today's earnings terms, follows a very similar trajectory to the fall in DB scheme membership[27]. It also means that just under half of the fall in the aggregate value of employer contributions to DB schemes is offset by an increase in the aggregate value of employer contributions to DC schemes.

[27] This trajectory is not quite identical owing to the assumptions made about people's salaries (see Annex 2)

Figure 17: Employer contributions – no pension reform



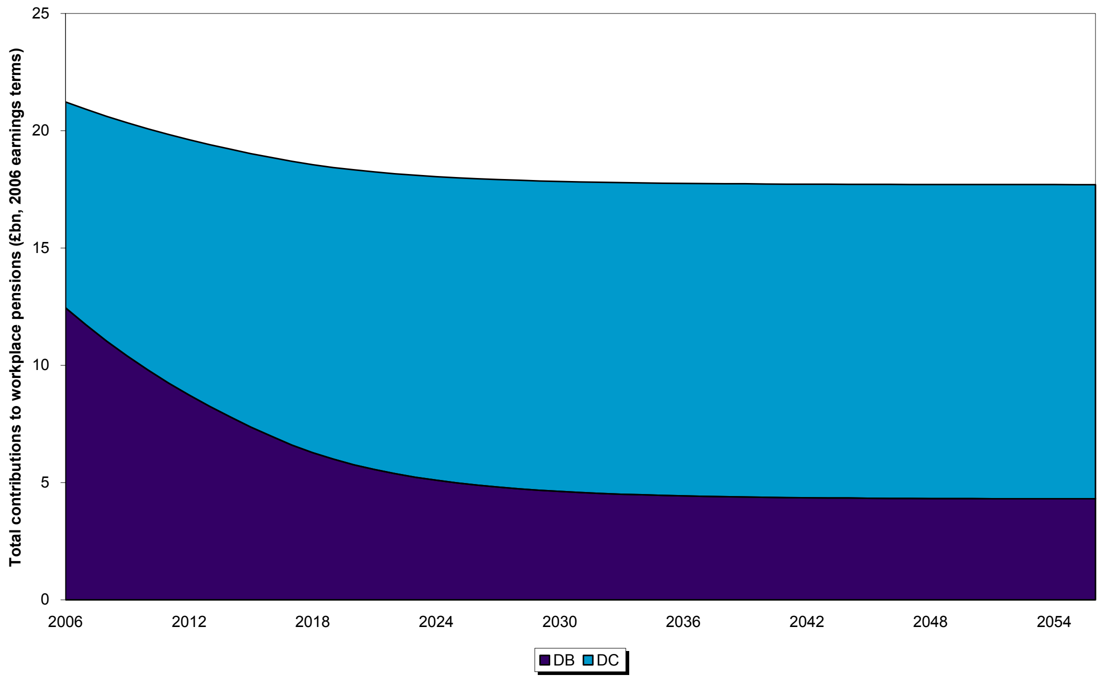
The average employer contribution rate falls from 9.3% in 2006 to 7.8% in 2016 as a result of the DB to DC shift. It then falls to 7.3% by 2026 and eventually levels off at 7.1%. Because employee contribution rates are slightly higher in DB schemes than in DC schemes, these also fall. The average employee contribution rate drops from 4.1% today to 3.8% in the long run.

Table 6: Average employer contribution rate – no pension reform

	2006	2012	2016	2026	2056
Employer	9.3%	8.3%	7.8%	7.3%	7.1%
Employee	4.1%	4.0%	3.9%	3.9%	3.8%
Total	13.3%	12.2%	11.7%	11.1%	11.0%

The difference between employee contribution rates in DB and DC schemes is less pronounced than the difference in employer contributions. This means that the decline in total contributions is less sharp than the decline in employer contributions. Compared with today's level, the aggregate value of all contributions falls by 8% (in today's earnings terms) by 2012 and by 17% in the long run.

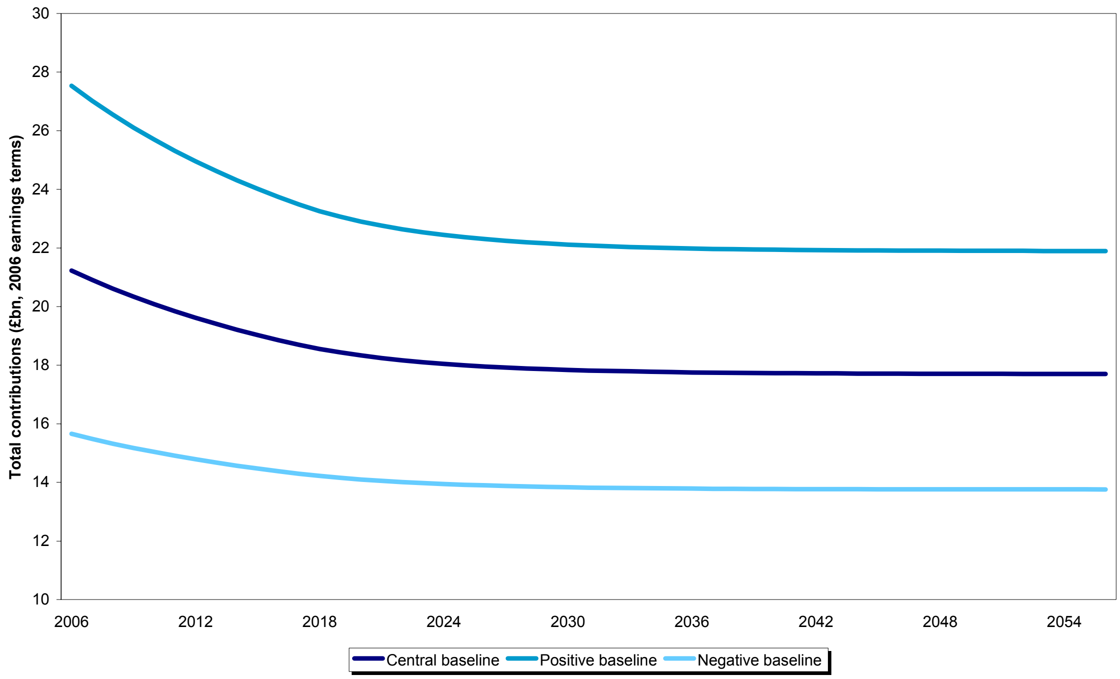
Figure 18: Total pension contributions – no pension reform



Inevitably, these results depend not just on how the model was constructed, but also on the assumptions made about today's pension landscape. Compared with the central case outlined in this Annex, the long-run level of pension contributions would be 24% higher if we had asked Deloitte to use the most positive input data available (in terms of membership levels and contribution rates). It would be 22% lower if we had asked them to use the most negative input data available[28].

[28] The positive baseline takes membership data from ASHE and DB contribution rates from the GAD survey; the negative baseline takes membership data and DB contribution rates from the Deloitte survey.

Figure 19: Possible counterfactuals compared



Annex 2: Modelling assumptions

The Deloitte survey asked employers to describe a simplified salary profile for their scheme membership alongside overall employee salaries. The mean salaries reported were £24,250 for DB scheme members, £25,500 for DC scheme members and £22,000 for non-members. In all scenarios, the aggregate value of contributions has been calculated by multiplying average contribution rates by average salaries (or average salaries minus £5,000 in the case of Personal Accounts) and by the number of members.

The modelling assumes that all individuals within each category are average individuals for that category in respect of both salary and contribution rates. The model works by transferring individuals from one category to another – e.g., from DB membership to DC membership. The effect is to change an individual's salary at the same time as their contribution rates change. This feature of the model could overstate the reduction in contributions that occurs when individuals transfer from workplace schemes to Personal Accounts. If so, it will understate the extent to which future contributions are concentrated in Personal Accounts and the extent of levelling down where individuals transfer from DB schemes to DC schemes as a result of pension reform.

Based on their own survey findings, Deloitte estimate that two-thirds of those eligible for auto-enrolment in 2012 and not already saving work for employers with some kind of pension provision in place in 2006[29], with the majority of these working for employers whose main open scheme is a DC scheme. One-third of employees auto-enrolled into workplace schemes and Personal Accounts are assumed to opt out[30].

Where employers level down to a mid-point contribution rate but keep a workplace scheme open, the midpoint contribution rate is applied to gross basic pay rather than banded earnings. This means that employee contributions can increase as a result of levelling down.

For simplicity, the changes that employers make in response to pension reform are all assumed to take effect from 2012. In practice, some of this levelling down (and potentially levelling up, where employers choose to auto-enrol staff into their existing schemes) may take place before 2012 as employers amend pension arrangements in advance.

[29] The Employer Pension Provision Survey puts this figure slightly lower, estimating that 55% of private sector employees not benefiting from employer contributions work for employers who provide contributions for at least some staff.

[30] In practice, opt-out rates are likely to be different for workplace schemes and for Personal Accounts, but it is not clear which will have the highest opt-out rates. Many of those auto-enrolled by employers with existing schemes will have already turned down the option of joining those schemes, so may be more likely to opt out. Offsetting that, higher contribution rates mean the incentives to remain in these schemes will be greater.

Annex 3: Employer motivation and the economics of pension provision

Why do employers provide pensions? Some may wish to behave paternalistically[31], or to strengthen their 'responsible company' branding. For most, however, pensions are a means to an end – a way of securing the services of the people they want to employ. NAPF members say the three main factors behind their decision to provide workplace pensions are 'to support organisational goals', 'to retain staff' and 'to recruit staff'[32].

Compared with wages and other benefits, employer pension contributions are a tax-effective way of paying people[33]. Pension contributions therefore represent good value for the employer – provided that the employees receiving them value these contributions appropriately. Paying contributions for employees with a 'live for today' mentality (or a high rate of time preference, as economists would call it) will not be such a rational use of a company's remuneration budget.

Some employers may therefore be happy to provide significant pension contributions, but only for employees who have signalled that they care about pensions. In practice, this can be achieved by limiting scheme membership to those who take an active decision to join the scheme.

From 2012, this option will no longer be available and the average value placed on pensions by scheme members should therefore fall. Even with this signalling system in place, just 36% of respondents to a recent CBI survey were satisfied with the value their employees placed on the pension scheme[34]. Companies who see pensions primarily as a recruitment and retention tool can expect to receive less 'bang' when they spend their pensions 'bucks' on individuals who only belong to the scheme as a result of inertia.

Employers faced with an increase in pension costs in 2012 will have to choose whether to absorb these through lower profits, or to pass them on through higher prices or offsetting reductions to labour costs. The Bank of England argues that profits will tend not to fall permanently in response to non-wage cost pressures, since businesses are required to

[31] However, Sir Digby Jones, then Director General of the CBI, argued that "the days of paternalism are over" when it comes to pensions (*Sunday Telegraph*, 25 October 2005).
[32] NAPF 2005 Annual Survey, volume 1, p35. Many traditional forms of pension scheme had features that helped retain staff and therefore to avoid the transitional costs involved in recruiting new staff and training them. Vesting periods meant that short-term staff would not benefit, while final salary schemes allow people expecting pay rises to increase the value of accrued rights by staying with the same employer.
[33] As well as not incurring an income tax charge as a benefit-in-kind, employer pension contributions are not subject to employees' or employers' National Insurance contributions.
[34] *A view from the top 2006*, CBI/Mercer HR Consulting, July 2006, p10.

deliver a rate of return that is set by international capital markets. As it is difficult to raise prices, much of the burden will be borne by employees[35].

For employers with no current pension provision, this means that the total wage bill must be lower than it would be without pension reform. If this is achieved by suppressing wage growth rather than by reducing staffing levels, employees who remain in Personal Accounts will receive a larger share of the employer's remuneration budget, at the expense of those who opt out. Employers already contributing more than 3% have more options. They can combine slower wage growth with lower per employee pension contributions in any number of ways. As few employers would find reducing nominal wages straightforward, employers with high contribution rates but low current participation rates will – at least in the short term – find it difficult to adjust to the cost of auto-enrolment by altering average wage levels alone.

With less ability to target pensions on those who value them, many employers with good schemes may decide that pensions must take at least some of the strain. Some may auto-enrol existing non-members and new recruits on terms that are less favourable than those currently on offer but still better than the minimum employer contributions to Personal Accounts. Others may level down all the way to 3%. Some may even alter the terms on which existing members can accrue new benefits. If employers do any of these things, there will be individuals who would have saved without pension reform who will now be able to do so only on less favourable terms.

[35] *Inflation Report*, Bank of England, November 2006, p30.

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