PENSIONS AND LIFETIME SAVINGS ASSOCIATION

# 2017 REVIEW OF AUTOMATIC ENROLMENT: RESPONSE BY THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

## "THERE IS MUCH TO DO TO ENSURE THAT THE POLICY REACHES ITS FULL POTENTIAL"

22 March 2017

PENSIONS AND
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ASSOCIATION

# EXECUTIVE SUMMARY

Automatic enrolment is working well but there is much to do to ensure that the policy reaches its full potential. We are pleased to be responding to the 2017 review and look forward to engaging with the review team over the course of the year.

## COVERAGE

The Association believes that the earnings trigger is set at roughly the right level and should continue to be set at £10,000. There are costs to this approach: the earnings trigger removes many people from the scope of automatic enrolment. But the costs of a lower trigger are potentially worse. In our view, lower earners are more likely to need to spend their earnings to cover living costs. There is limited value in someone with earnings below £10,000 saving in order to augment a full state pension which is worth not much less than the value of the earnings trigger.

The scope of the policy though, is not yet optimal. There is a clear policy case for including three categories of people within the scope of the policy:

- Younger people would save more and potentially be able to retire earlier if they began saving at age 18.
- Self-employed people are unlikely to be saving into a pension and should have the opportunity to be included.
- Low earners with total earnings in excess of the trigger from more than one job are designed out of the policy.

While the means by which these populations should be included within the scope of automatic enrolment is not yet clear, the review is an important opportunity to decide exactly this sort of technical matter.

There should, though, be no reduction in the scope of automatic enrolment on a sectoral basis. Such a move would potentially set in train the broader erosion of the scope of automatic enrolment. The so-called "gig economy" illustrates the way that labour market flexibility may be taken advantage of to erode the rights of workers more generally. Government should beware this possibility.

## ENGAGEMENT

We see three aspects to the engagement debate. First, there is a need for government to act to raise the salience of pension saving. The immediate policy need here is for a campaign to support phasing and ensure that coverage levels remain high. But we think that a longer term approach is also necessary as we try to build up automatic enrolment from a base of 8 % of band earnings.

Second, there is the need to promote much greater engagement with pension savings with a view to making the pension freedoms work effectively. While the pension freedoms are not the only reason to encourage engagement, they have created a need to get people to engage with their savings ahead of a decision or decisions at the point of decumulation. We believe that the right intervention here will probably consist of government and provider communications alongside a default system that preserves individual choice but ensures that the line of least resistance leads to a stable retirement income rather than a cash lump sum.

Third, there is a need for this to be done by government. Many employers have a more transactional relationship with their employees and may see automatic enrolment as a compliance matter rather than an employee benefit.

There is a good level of expertise within the PLSA membership about how to communicate with employees about pensions and spur them to action. This typically requires a significant commitment of time and resources from an employer that is already committed to running a high quality pension scheme. These employers often see the pension scheme as an integral part of their benefits offer and are paying contributions well in excess of the statutory minimum. They may well have an objective to raise participation and the level of contributions within the scheme.

Finally, the pension dashboard and other technological tools offer promising routes to engagement. The Association believes that there should either be a single dashboard or a dashboard run and promoted by the new single guidance body to act as a single, trusted, reference point. We are also optimistic that new forms of engagement, including robo-advice might offer a route to resolving engagement problems at decumulation.

## CONTRIBUTIONS

The Association believes that there is a clear policy case for raising statutory minimum contributions to at least 12 % of band earnings at some point in the next Parliament. This is based on research and modelling conducted last year and published as “Retirement Income Adequacy: generation by generation”.

In part, this is because many of the drivers of higher contributions are spread unevenly through the economy. Many employers place a high premium on pension provision, either for cultural reasons or reasons related to HR strategy. These employers are probably in the minority: the collapse in workplace pension provision coincided with the longest economic boom in living memory. It is clearly possible to hire and fire effectively in the bulk of the economy without offering a workplace pension.

Raising contributions is a medium term issue, though. We believe that it is necessary to ensure the success of staging and phasing to be concluded before a firm decision on contributions rates can be taken. A decision on how and when to increase automatic enrolment contributions should be a priority in the next Parliament.

We are sceptical about the value of some policy tools for raising contributions. Automatic escalation is clearly effective within employers with stable workforces and the prospect of pay increases. For those experiencing high churn and low wage growth, it is much less likely to be effective.

## CHARGE CAP

There are advantages and disadvantages to lowering the charge cap on qualifying default funds. There are similar advantages and disadvantages to including transaction costs within the scope of the cap. While both measures might make workplace pensions cheaper and in the latter case may make overall price more transparent, we believe that the disadvantages outweigh the advantages.

At the moment, there is no consensus on what constitutes value for money in workplace pensions. This matters as it is difficult to regulate price without an idea of value for money. It would be possible to reduce the price of workplace pensions such that they were cheap but of poorer quality than a higher priced alternative.

Last, a lower charge cap would reduce scope for diversification by taking higher cost asset classes out of scope. In a similar vein, a cap that included transaction costs would potentially create a perverse incentive not to transact, even when that was in the best interests of members. We do not believe that a hard cap would be possible and that a cap on a “comply or explain” basis would be preferable.

## INTRODUCTION

**We're the Pensions and Lifetime Savings Association; the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and over 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.**

**Our purpose is simple: to help everyone to achieve a better income in retirement. We work to get more money into retirement savings, to get more value out of those savings and to build the confidence and understanding of savers.**

We are pleased to be taking part in the 2017 review of automatic enrolment. The Association has supported automatic enrolment since the inception of the project. Now, the Association's members are taking a leading role in providing workplace pensions to the bulk of the 7 million people who have been drawn into pension saving.

Right now, it seems that we are in the early stages of a policy success. Implementation has been smoother than expected and well towards the upper end of reasonable expectations. Opt out rates are low and there has been no sign yet of any capacity crunch or other operational failure that might undermine the policy.

Furthermore, the maintenance of aim shown by successive administrations in pushing on with the policy is a testament to the power of consensus based policy making. Automatic enrolment shows that government, employers and the financial services industry can collaborate effectively towards a shared, long-term goal.

The Government is right to state that a firm policy recommendation on raising statutory minimum contributions is premature. We need to ensure the success of staging and phasing and look towards a decision in the next Parliament.

We believe, though, that modelled evidence points towards a rise in minimum contributions to at least 12 % of band earnings as desirable. We think that any review process is likely to expose and then firm up a consensus around a figure in that range. This should not be a surprise, the final report of the Pensions Commission recommended 8 % of band earnings as a minimum contribution rate anticipating that it would lead to a replacement rate totalling 45 % for a median earner.

While the evidence, therefore, is reasonably clear-cut, the path to higher minimum contributions should be gradual and considered. More broadly, the review is an excellent and timely opportunity to ensure that the initial success of automatic enrolment is maintained and the policy develops towards its full potential.

# BACKGROUND AND OBJECTIVES

## WHOLE SYSTEM REFORM

The UK's pensions system is in transition. The emerging system features a first pillar, the basic state pension, which will be sufficient to take care of the most basic needs.

The second pillar now features a system of quasi-compulsory workplace pensions available to most people in work. Most people in the labour market, other than low earners and the self-employed will become pension savers by default. Most of these people, outside of the public sector will save into DC pension products. If responsibility for minimum basic needs in retirement has been taken by the state, automatic enrolment places responsibility for income replacement above this minimum firmly on the individual.

Ensuring that the current relationship between the two pillars is maintained and the uprating mechanism used to increase the value of the state pension is sustainable is of the highest importance. The PLSA has proposed that the value of the state pension should be maintained at around 30% of median earnings.

## COVERAGE

### DO THE EARNINGS TRIGGER (£10,000 IN 2017/18) AND AGE CRITERIA (22 TO SPA) CONTINUE TO BRING THE RIGHT PEOPLE INTO AUTOMATIC ENROLMENT?

The Association believes that the earnings trigger is currently set at the right level (£10,000). The UK is on a path to a basic state pension set at or around the OECD poverty line and augmented by means tested benefits. In that context, where the state pension will replace c.80 % of pre-retirement income it does not make sense for an individual to save if they have an income much below the earnings trigger. It should make more sense for those individuals to spend the money they earn rather than save in the expectation of a higher income in retirement than the one they currently have.

There will be individuals for whom this is the wrong thing. It is in the nature of setting default positions at the population level for that to be the case. For example some lower earners will be part of higher earning households. It is not currently well understood how many low earners are in this situation so we believe more research is needed before fully informed policy positions can be made in this area. Nevertheless, in the interim we suggest that the Government could choose to highlight further the benefits of opting in.

The Association also believes that there may be a case for bringing younger workers into the scope of automatic enrolment. In Retirement Income Adequacy: Generation by Generation, the Association modelled different contribution rates scenarios for the population of Britain. Our findings showed that a statutory minimum contribution level of 12 % with a later retirement age had a dramatic impact on younger individuals eventual replacement rate. So, working longer is potentially more effective than a higher contribution rate in some modelled scenarios. It is also, potentially unpopular. Starting saving sooner  should have a similar effect but without the unpopularity of later retirement and the merits of this should be investigated further.

#### BOX 1: THE IMPACT OF NET PAY AND RELIEF AT SOURCE ON SAVINGS

The earnings trigger is also intrinsically linked to the net pay/RAS issue. The net pay/RAS issue arises for individuals who contribute to a workplace pension through net pay arrangements but who have earnings below the lower threshold for income tax do not automatically receive tax relief. This is because net pay arrangements involve a pre-tax deduction from pay. At the moment, we believe the number of individuals this applies to is small and the amounts of money low. As phasing begins the sums of money concerned may rise. It will be necessary to consider the future of this issue over the course of the review.

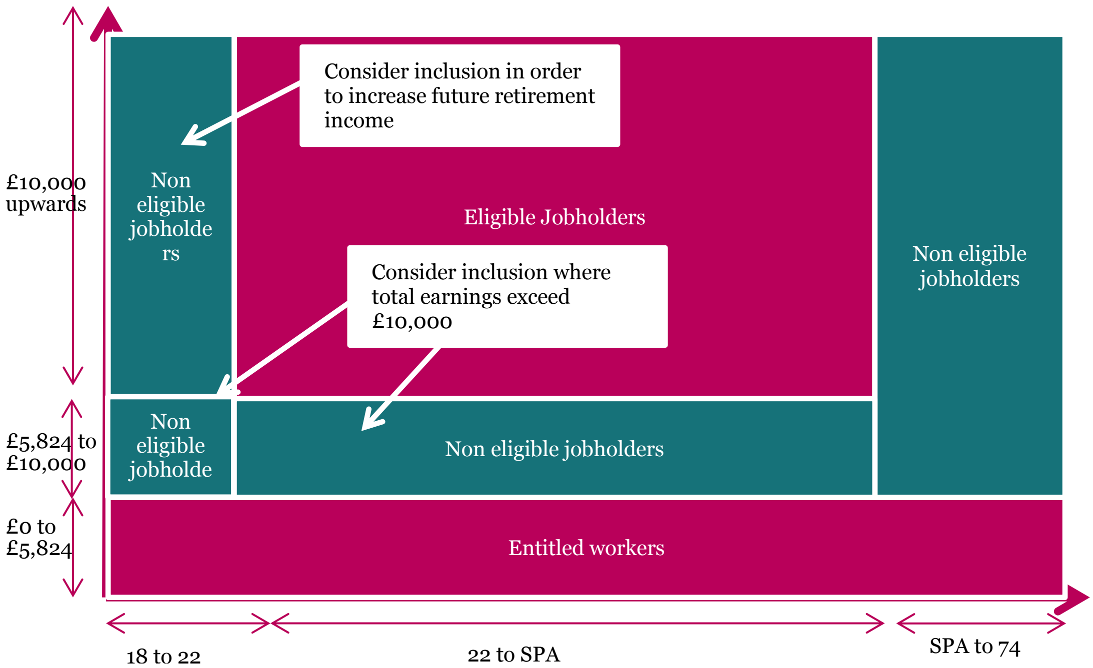
## IS THERE A CASE FOR BRINGING INDIVIDUALS NOT CURRENTLY ELIGIBLE FOR AUTOMATIC ENROLMENT INTO SCOPE, AND ON WHAT GROUNDS?

Yes. We believe that there is a case for potentially bringing three categories of people into the scope of the regulations:

- Younger workers
- Low earners with multiple jobs amounting to income over the £10,000 trigger
- Self-employed people

Two of the three are shown in figure one, below.

### FIGURE 1: APPLYING THE REGULATIONS: A VISUAL REPRESENTATION




We believe that there is potentially a case for including some younger workers within the scope of automatic enrolment. In Retirement Income Adequacy: Generation by Generation, the Association modelled different replacement rate scenarios for the population of Britain. Our finding showed that working longer is potentially more effective than a higher contribution rate for some individuals.

Working after SPA, though is also, potentially unpopular and also inequitable. Some, for whatever reason, may simply be unable to continue working past SPA. This might be the case if they entered a manual profession at a young age and are unable to retrain once no longer physically able to work.  Starting saving sooner might have a similar effect and ensure that those who cannot retire later have the best possible chance of maximising their savings. Using the NEST pension calculator shows that for an individual saving 8 % of a 22,000 salary until SPA, total pot size is projected to be £220,000 at retirement if saving begins at 18 and £191,000 if saving begins at 22.

The four additional years in the model equate to c. £39,000, vastly in excess of contributions made in those years.

The second category is low earners who have earnings above the earnings trigger from more than one source.

The third category is the self-employed. By self-employed we mean people who are registered as self-employed with HMRC not sole directors of service companies. The number of self-employed people in the UK increased by c. 730,000 between 2008 and 2015, split roughly evenly between full and part time self-employment[1]. This has been accompanied by a decline in funds flowing into the pensions of self-employed people. In 2007/08 self-employed people made c. £3.5bn of pension contributions and by 2015/16 this had fallen to £1.7bn. This was mainly a fall in the proportion of the self-employed saving into a pension.[2]

There has been a significant expansion in the numbers of self-employed people since the financial crisis. Over the course of the review, there will be a need for significant further analysis of the self-employed as a group.

### DO THE CATEGORIES OF NON-ELIGIBLE JOBHOLDERS AND ENTITLED WORKERS CONTINUE TO MAKE SENSE IN TERMS OF ENABLING THOSE WHO ARE NOT ELIGIBLE TO BE AUTOMATICALLY ENROLLED TO SAVE INTO A WORKPLACE PENSION?

These categories continue to make sense. If we choose to apply an earnings trigger then there will always be categories of people to whom the duties do not fully apply. While we think that the size of the non-eligible job holder category should be reduced, we believe that the categories are conceptually sound.

### IN THE LIGHT OF THE CONTINUING EVOLUTION OF THE LABOUR MARKET, IS THERE A CASE FOR EXEMPTING ANY GROUP OR GROUPS OF EMPLOYERS FROM AUTOMATIC ENROLMENT DUTIES?

We believe that there should be no reduction in the scope of automatic enrolment on a sectoral basis. Such a move would potentially set in train the broader erosion of the scope of automatic enrolment. The so-called “gig economy” illustrates the way that labour market flexibility may be taken advantage of to erode the rights of workers more generally. Government should beware this possibility.

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[1] ONS (2016) *Trends in self-employment in the UK: 2001 to 2015* https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/articles/trendsinselfemploymentintheuk/2001to2015#executive-summary

[2] ONS (2017) *Personal pensions: retirement annuity contracts and free standing Additional Voluntary Contributions* (PEN1) https://www.gov.uk/government/statistics/personal-pensions-retirement-annuity-contracts-and-free-standing-additional-voluntary-contributions

## HOW CAN SELF-EMPLOYED PEOPLE BE ENCOURAGED AND ENABLED TO SAVE MORE FOR LATER LIFE/ FOR RETIREMENT?

We believe that the review should consider bringing self-employed people into the scope of automatic enrolment. As things stand, there is still no consensus as to what model is most appropriate to achieve the desired objective. We believe that we need a debate over how best to achieve this goal over the course of the review that takes in not only the effectiveness of competing models but also their operational challenges.

## ENGAGEMENT

### THERE IS A ROLE FOR COMMUNICATIONS IN AUTOMATIC ENROLMENT

Automatic enrolment exists because it has proved very difficult to encourage pension saving through voluntary methods alone. It is not clear exactly what combination of factors causes people to under-save if left to their own devices but successive real-life experiments have time and again demonstrated the phenomenon. It can be seen most clearly in the decline in workplace pension membership that automatic enrolment has reversed.

It is important, therefore, that pensions communications operate with the grain of automatic enrolment. By this we mean that they aim to enhance, rather than disrupt automatic enrolment. That may mean that the primary aim of some automatic enrolment communications is to get people comfortable with a default or help establish it as a new social norm rather than to engage members directly or prompt action.

In the scheme case studies shown later in this section, the general theme is the interrelationship between communications, the design of particular elements of the scheme and the use of behavioural techniques. Where done well, these elements complement one another, for example to highlight the existence of employer matching of contributions and use a behavioural element. That might mean highlighting that an individual might be “missing out”.

Automatic enrolment already lends itself to this approach with the combination of the employer contribution, high quality provider communications at the point of enrolment and the “nudge” provided by automatic enrolment itself. There is an established literature on how to go about this, including the DWP’s initial research on communications to support automatic enrolment[3] and the NEST “golden rules of communication”, which synthesised existing research into a how-to guide[4]. While these are not new publications, we still think the findings and principles behind them are still relevant.

### TAKING ACCOUNT OF ENGAGEMENT HEADWINDS

Good communications should also take account of the factors that make automatic enrolment necessary. We see those principally as being low levels of financial

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[3]The Futures Company (2011) *Automatic enrolment – information for workers qualitative research*
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220315/comms-res-auto-enrol-0711.pdf

[4] NEST (2012) *NEST’s golden rules of communication: Talking about pensions with a new generation of savers*
https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/golden-rules-of-communication,PDF.pdf

capability in relation to pensions and other investment products and the various behavioural biases that compromise individual decision making about money.

We see pensions communications strategies as being hampered by low levels of financial capability (underpinned by low levels of maths/reading ability) that are fundamentally fixed. Only c. 25 % of the UK population has maths skills above level 2 (A* to C at GCSE)[5]. We tend to see critical determinants of financial capability as being largely set during compulsory education and being very hard to shift thereafter.

This means that while people are often very good at managing a household budget, a skill that is common across the earnings distribution, they may feel less confident with money or financial products in other areas[6]. Where people need to understand something unfamiliar, or where developing understanding requires a higher level of mathematical skill or reading comprehension than they possess, they are more likely to find this difficult.

The interrelationship between low levels of financial capability and the various cognitive biases towards which people are prone significantly complicate communications efforts. It is important to be clear here that this is not about regarding people as being too unintelligent to make decisions about pensions and other financial products. Behavioural biases may affect the "highly skilled" in similar ways to the inexpert[7].

This means that the role for pensions communications is necessarily limited, perhaps more so than in other product and service markets. Those setting policy need to be mindful of the risks of putting more weight on communications as a policy lever than it can bear. But there is an important role for communications in supporting good policy and product design, which we discuss in the subsequent sections of this response.

### THE PENSIONS DASHBOARD INITIATIVE

The pensions dashboard will allow individuals to see all their pension entitlements on an online portal. There is still disagreement about how this initiative should proceed. The Association sees a high profile public dashboard hosted by a public body as the best way to promote uptake.

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[5] BIS (2012) *BIS Research Paper 81: The 2011 Skills for Life Survey: A Survey of Literacy, Numeracy and ICT Levels in England* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/36000/12-p168-2011-skills-for-life-survey.pdf

[6] MAS (2015) *Financial Capability in the UK 2015* https://prismic-io.s3.amazonaws.com/fincap-two%2Fd08746d1-e667-4c9e-84ad-8539ce5c62e0_mas_fincap_uk_survey_2015_aw.pdf

[7] FCA (2013) *Applying behavioural economics at the Financial Conduct Authority* https://www.fca.org.uk/publication/occasional-papers/occasional-paper-1.pdf

The PLSA sees potential in the dashboard. Virtual aggregation of pension pots will allow savers to see just how much money is at stake. That may prompt much greater levels of engagement with pensions than we see at the moment.

### TOWARDS A WAY FORWARD ON PENSION COMMUNICATIONS

Despite the difficulties, there is a major role for communications in supporting automatic enrolment and, potentially, driving greater engagement with savings. We see several aspects to this.

First, there is a need for government to act to raise the salience of pension saving. The immediate policy need here is for a campaign to support phasing and try and ensure that coverage levels remain high. But we think that a longer term approach is also necessary as we try to build up automatic enrolment from a base of 8 % of band earnings.

Second, there is the need to promote much greater engagement with pension savings at the point of or in front of decumulation. While the pension freedoms are not the only reason to encourage engagement, they have created a need to get people to engage with their savings ahead of a decision or decisions at the point of decumulation. We believe that the right intervention here will probably consist of government and provider communications alongside a choice architecture that ensures that the line of least resistance leads to a stable retirement income rather than a cash lump sum.

Third, there is a need for this to be done by government. Many employers see automatic enrolment more as a compliance matter than as a workplace benefit to be valued. There is a good level of expertise within the PLSA membership about how to communicate with employees about pensions and spur them to action. This typically requires a significant commitment of time and resources from an employer that is already committed to running a high quality pension scheme. These employers often see the pension scheme as an integral part of their benefits offer and are paying contributions well in excess of the statutory minimum. They may well have an objective to raise participation and the level of contributions within the scheme.

Realistically, this does not describe all employers across the UK economy. Many have a more transactional relationship with their employees and may see automatic enrolment as a compliance matter rather than an employee benefit. In that context, while we think a trusted employer is a better site for communications than government, there is a role for government in reaching workers across the whole UK economy.

### WHAT EXAMPLES ARE THERE OF EFFECTIVE COMMUNICATIONS AND ENGAGEMENT TOOLS THAT HAVE DELIVERED:

1) SUSTAINED WORKPLACE PENSION SAVING OVER THE LONG TERM, AND

### 2) INCREASED LEVELS OF SAVINGS RESULTING FROM CHANGING CONTRIBUTION RATES?

Box 1 shows two case studies that illustrate best practice in pensions communications. The common theme here is the relationship between communications, including targeted communications, the employer match and behavioural techniques. As noted earlier, it is important to consider how contributions structure design and other aspects of the pension scheme fit together with the communications effort.

### BOX 2: COMMUNICATIONS CASE STUDIES

Case study 1: **Telefonica/O2**

Recently Telefonica/O2, a PLSA member outlined to the Association how they had revised their communications approach. The approach highlights the importance of a strategy that uses communications, behavioural techniques and contributions structure to achieve a particular result.

- Telefonica launched a scheme website, intended as a place for scheme members to be able to answer questions about the scheme and act as a repository for important information.
- They developed a modelling tool that allowed individuals to see the impact of additional pension contributions on their fund size at retirement.
- They segmented their membership and employee base and tailored their communications channel to each segment. E.g. email for active members of the scheme and employed non-scheme members.
- They further subdivided their segmentation to target scheme members not taking full advantage of the employer match and to suggest that they increase their contributions.
- Finally, they used behavioural techniques to enhance the effectiveness of their communications e.g. “people are getting something you are not”.

Case study 2: **Nationwide**

Nationwide changed their contribution structure last year, including a substantial increase of both the default employer and employee contribution. They increased their core employer contribution to 13 % and their core employee contribution to 7 %, which resets to 7 % each year. This approach was backed by an extensive multi-channel communications campaign, information cascade, direct communications and film. It has resulted in a stable 80 % of employees paying more than a 4 % employee contribution.

### IN AN INDIVIDUAL’S AUTOMATIC ENROLMENT JOURNEY, WHAT ARE THE MOST AND LEAST EFFECTIVE TOUCH POINTS WHEN APPROPRIATE ENGAGEMENT CAN HELP REINFORCE PERSONAL OWNERSHIP OF

**PENSION SAVING? WHAT FORM SHOULD THAT ENGAGEMENT TAKE, WHO SHOULD DELIVER IT AND HOW?**

The PLSA shares much of the pensions sector's enthusiasm for a communications approach based on touch points. It seems intuitively plausible that there are points where individuals are more open to considering their pension savings and planning for the future. It also seems intuitively plausible that willingness to consider pension saving might increase with age as the salience of retirement increases.

Suitable touchpoints here might include significant birthdays and life events, including house purchase, marriage and the birth of children. At the moment, though, there is limited evidence as to the effectiveness of this sort of approach. It will be important to conduct research into the opportunities presented by a touch-point based communications approach and compare that with non-touch point based communications.

## CONTRIBUTIONS

Over the course of 2016 the Association, together with Hymans Robertson and the Pensions Policy Institute, undertook a project to model the adequacy of future retirement income in Great Britain.

The Government estimates that around 10 million people will be newly saving as a result of automatic enrolment by 2018. For the population covered by our modelling, we estimate that there will be 7.2 million individuals who were not contributing to a pension in 2013, and will therefore be newly saving into DC schemes as a result of automatic enrolment. We estimate that on average, individuals will be an additional £2,500 per year better off in retirement (in today's prices) as a result of being automatically enrolled; for those in the 22 to 34 age group, they would be better off in retirement on average by around £4,000 per year (in today's prices).

Despite this progress, as things stand, many individuals are not on target to attain the Pensions Commission's definition of an adequate retirement. This is not, in the main, the result of current policy failing to deliver its objectives. The target for statutory minimum contributions, 8% of qualifying earnings, was intended to achieve a replacement rate of around 45%, with the remaining 15-22% being made up of additional voluntary contributions. Rather, many people are not on track to achieve an adequate retirement income due to a combination of past developments, such as the gradual decline of DB pensions from the mid-1990s; the failure of attempts to stimulate voluntary saving in the 1990s and early 2000s; rising longevity; and the impact of relatively poor market conditions.

#### BOX 3: METHODOLOGY

In the analysis, we used the Wealth and Assets survey ("WAS") to provide a detailed snapshot of the nation's pension wealth and contributions in 2012-14.

Overlaying this information with assumptions about the subsequent progression of automatic enrolment, we then used Hymans Robertson's Guided Outcomes ® methodology to project likely retirement incomes for nearly 800 stylised individuals, obtained by segmenting the c. 40,000 individuals in the survey into representative groups and scaling them up to a population level of c. 25.5 million. We then compared these against two markers of adequacy: an updated version of the replacement rates used by the Pensions Commission and the Joseph Rowntree Foundation's minimum income standard.

This manifests at a more granular level as a generation by generation story, with markedly different prospects for each of the three generations we identified.

### MILLENNIALS: THE AUTOMATIC ENROLMENT GENERATION (CURRENTLY AGED 22-34)

Those furthest away from retirement will be the first to experience the UK's pension system as intended by the reforms of the last decade. This cohort benefits from the combination of the full basic state pension and savings resulting from automatic enrolment over a full working life. As things stand, this combination will not on its own get this group to an adequate retirement income as defined by the Pensions Commission's proposed target replacement rates. Automatic enrolment is expected to generate the level of retirement income originally envisaged for this group, but there is no evidence that Millennials are accruing the levels of additional voluntary savings the Commission anticipated.

Our findings show that higher pension contributions, at least 12% along with a later retirement date, could meet the gap created by the absence of voluntary additional saving and would probably bring this group close to an adequate retirement income as defined by Pensions Commission replacement rates. There is no room, however, for complacency, Millennials face new challenges in saving, in particular, the high cost of housing and accommodation, and many will have additional costs, such as student debt.

### GENERATION X: THE IN-BETWEEN GENERATION (CURRENTLY AGED 35-54)

This generation's story is defined by two events: the first is the decline of DB pensions and the subsequent failure of policies in the 1990s and early 2000s intended to get more people to save voluntarily in DC. The second is the roll-out of automatic enrolment. This meant that many of these individuals went through the early phases of their working life without accruing any pension savings. Many are now making pension savings at too low a level to reverse this shortfall.

The distance to adequacy is much greater for this group than for the Millennials. Albeit, automatic enrolment will make a difference to their overall level of retirement income and some higher earners will have legacy state second pension (S2P) entitlement that is worth more than the state pension assigned to them in our modelling. A strategy focused purely on increasing pension contributions is unlikely to succeed, so to achieve an adequate income this generation may need to work longer and, if available, utilise property or other forms of accumulated wealth to derive a higher retirement income. We recognise that for many individuals faced with ill health or working in certain manual occupations, working longer is simply not a possibility. This group need to be alerted to the potential challenges they are facing and the opportunities, even if limited, for improving their retirement income. Ultimately, this is a policy challenge for government to address with some urgency.

### BABY BOOMERS (CURRENTLY AGED 55-SPA)

The situation for the Baby Boomers reflects the long-running inequality that has been created by the UK pensions system. Some people, especially those who have accrued DB pension entitlement, have very good retirement income prospects but others, around half, have quite poor ones. Even though the latter group may now have been automatically enrolled, the short period (10 years or less) they have left to retirement means that they will depend largely on their state pension entitlement.

There is little that can be done in the time left before retirement for this group to substantially alter their position. While increasing pension contributions for this group will increase the amount of cash available during retirement it is unlikely to materially alter their income replacement rate. Only working longer is likely to make a real difference as this will both increase the amount saved at the same time as it decreases the amount of time in which their assets will need to be used up; though we note again that this may not be possible for all. More positively, a majority in this generation have some property wealth which might be drawn upon to support their income.

## CONCLUSIONS

Our research shows that automatic enrolment is on a path to substantially raise the retirement incomes of many people in the UK. It will not though, as things stand, bring everyone up to the replacement rates suggested as adequate by the Pensions Commission.

The Commission proposed that automatic enrolment should deliver around 45% of previous earnings for a median earner and that the remainder of their proposed target replacement rate of 67 % would be achieved through voluntary saving. While those who have accrued a reasonable amount of DB pension are on course to achieve the adequacy targets, for those who mainly have DC pension savings, there is a gap.

It is clear therefore, that default automatic enrolment contributions will need to rise in the future from the current target of 8% of qualifying earnings up to at least 12% and that it may also be necessary to supplement this with additional voluntary contributions and an increase in their working lives. This runs counter to the general view that “Millennials will never be able to afford to retire”.

We believe that the timing and pace of change should be considered after the current phased rise of contributions from today’s 2% of qualifying earnings up to 8% by 2019 is completed. This would also be the right time to consider the right way to share the cost of additional contributions between employers and the employee. To take decisions on this earlier would pre-judge the success of staging and phasing when the success of both is still to be fought for. For older savers, those in Generation X and the Baby Boomer generation, additional saving at 12% of salary will help improve retirement incomes but will not achieve target replacement rates. To achieve an adequate income in retirement they will almost certainly need to work longer and, where they have it, use other forms of wealth, such as property wealth.

Issues of how much and when to increase contributions for Millennials, and for other generations with less time to save, are complex and can be contentious. We believe these issues cannot be worked through in the time scale currently planned for the 2017 review of automatic enrolment given the need for significant engagement with a diverse range of stakeholders, further research, and the current critical stage in the roll out of automatic enrolment. As part of the 2017 Automatic enrolment Review the Government should instead commit to the creation of an independent commission with a remit to: review existing measures of adequacy and make recommendations for a national standard or standards which reflects the changing nature of retirement; make recommendations for increasing minimum contribution levels to at least 12% of salary including how and when this change should be made, and how it should be divided between worker and employer contributions; and make additional recommendations to improve the situation of older savers who have less time to benefit from an increase in contribution rates.

## WHAT ARE THE KEY DRIVERS, OPPORTUNITIES AND BARRIERS FOR INDIVIDUALS AND EMPLOYERS THAT MAY AFFECT THEIR BEHAVIOURS IN RELATION TO SUSTAINING EXISTING, OR MANAGING INCREASING, CONTRIBUTION RATES?

Drivers of contributions behaviour fit into two different categories.

### EMPLOYER

Employers may choose to pay higher contributions for a number of different reasons:

- Higher contributions form part of a pay and reward strategy: pension contributions may be required to attract high quality employees. Higher contributions may also enable employees to retire by a given date, enabling employers to manage out retirees. It is important to remember, though, that this may only affect a portion of a firm's workforce. Firms may still operate multiple schemes for different categories of employee with different contribution rates for each.
- Higher contributions may reflect a more paternalistic attitude.
- Higher contributions may form part of a "deal" struck with employees following the closure of a DB scheme or some other workplace agreement.

Conversely, the reverse is true of almost all of those factors. Employers who have a more transactional relationship with their workforces may not see the need for higher pension contributions. These employers may be approaching automatic enrolment more as a compliance matter than a pay and reward issue.

Furthermore, the UK is currently a low pay growth economy[8]. Since the beginning of 2008, pay growth has averaged 1.8 %. There has been a significant growth in self-employment, some of which may represent employers pushing the boundaries of labour market regulation. In this context, employers may be either economically

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[8] ONS (2017) Average weekly earnings dataset https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsearn01

unable to make higher pension contributions or may simply not see the necessity from a recruitment and retention perspective.

Last, employers currently struggling with a DB deficit issue may be unwilling or unable to make higher contributions.

### EMPLOYEE

Pension contributions are typically low salience for employees. This can clearly be seen from the dip in pension saving that occurred prior to the introduction of automatic enrolment in 2012. As noted earlier, there are examples of high quality engagement, which have driven up savings rates in individual businesses. The default, though, is disengagement and this partly explains the low average total contribution to workplace pension schemes in the UK of 4 %[9].

### IS THERE SCOPE FOR A MORE FLEXIBLE APPROACH TO CONTRIBUTION RATES TO REFLECT AN INDIVIDUAL'S LIFE AND EMPLOYMENT JOURNEY?

The Association is not immediately supportive of this idea. We are instinctively cautious of approaches that might encourage people to save less at different points in the lifecycle. Once contributions are reduced, it may be difficult to increase them again. Furthermore, this adds a degree of operational complexity that the market may currently find it difficult to adjust to.

We do not believe that this would be as effective in achieving an adequate retirement as an overall increase in statutory minimum contributions.

### DO YOU HAVE ANY EVIDENCE OR VIEWS ON THE MOST APPROPRIATE/EFFECTIVE BALANCE BETWEEN EMPLOYER AND INDIVIDUAL CONTRIBUTION LEVELS? WHAT ARE THE OPTIONS FOR ENCOURAGING, 'NUDGING' AND ENABLING PEOPLE TO SAVE MORE INTO THEIR WORKPLACE PENSION?

The general consensus on employer matching is that the existence of the match has a weak positive impact on participation rates but that it has a strong impact on the amount that individuals end up saving.[10] Individuals are likely to save up to the amount of the employer match and no more than that or they are likely to save the amount they need to obtain the maximum employer match. As can be seen from the case studies elsewhere in this response, employees can be encouraged through communications to the maximum match through a combination of communications and behavioural techniques.

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[9] ONS (2016) Occupational pension schemes survey https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionssavingsandinvestments/bulletins/occupationalpensionschemessurvey/previousReleases

[10] Madrian B (2013) *Matching Contribution Savings and Outcomes: a behavioural economics perspective* in Hinz R et al ed. (2013) Matching Contributions for Pensions https://openknowledge.worldbank.org/bitstream/handle/10986/11968/735130PUB0EPI001070120date010025012.pdf

This is probably because individuals take a signal from the level of the employer contribution as to what they themselves should be saving. The implication of this is that the employer contribution and any contribution from government through tax relief should at least equal the employee contribution.

## AUTOESCALATION

There has been much discussion of auto-escalation, a device by which people pre-commit to saving all or a proportion of future pay rises. The US literature on auto-escalation and the limited number of attempts made to embed it within single employer schemes in the UK show that it is effective as an intervention.[11] Auto-escalation may achieve increases in contributions to pensions that might otherwise not have been possible or forthcoming.

Auto-escalation is a good example of a strategy that does not scale well. It works well in companies where employees tend to stay employed for long periods of time and also where they get regular pay rises. This implies a paternalistic employer being willing to embed auto-escalation and a culture and operating model in which employees develop and progress.

Auto-escalation is less well suited to higher turn-over environments and jobs or sectors where pay progression is limited. It is also perhaps less well suited to lower paid jobs where people may actually need to spend pay rises in order to maintain a given standard of living. This may be as a result of differing sensitivity to inflation and also the impact of inflation on household consumption.

The key issue is that there is no technical solution to the issue posed by job churn. In order for automatic escalation to be effective over time, an individual's contribution rate would need to follow them as they move from job to job, otherwise it would reset itself. Until there is a resolution to this issue, which is technically difficult rather than impossible to resolve, automatic escalation will remain short of its potential as a device.

## TO WHAT EXTENT ARE INDIVIDUALS SAVING OUTSIDE OF A WORKPLACE PENSION FOR RETIREMENT AND HOW DOES THIS IMPACT ON THEIR INTEREST AND ABILITY TO SAVE INTO A WORKPLACE PENSION?

Figure 2 shows median wealth by age group for three groups of individuals taken from wave four of the wealth and assets survey (Millennials 22-34, Generation x 35-54 and Baby Boomers 55+). As can be seen, median levels of wealth outside of pensions are typically quite low, with most older people only holding significant non pension wealth in their properties.

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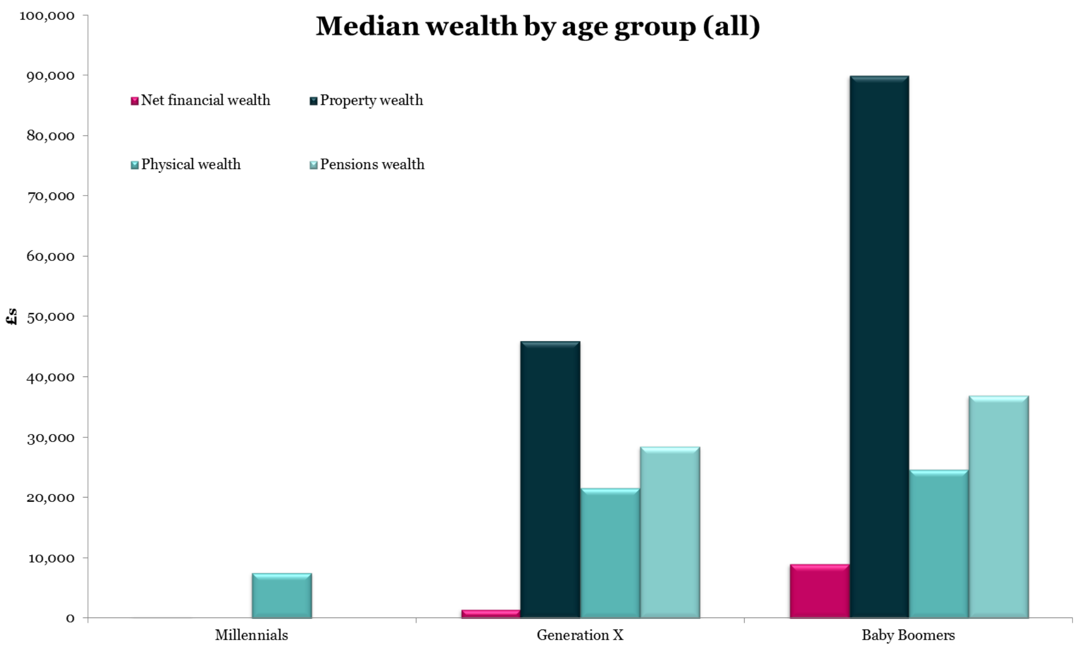
[11] Thaler R. and Bernatzi S. (2004) S*ave More Tomorrow: Using Behavioral Economics to Increase Employee Saving* in Journal of Political Economy, 2004, vol. 112, no. 1, pt. 2 http://faculty.chicagobooth.edu/richard.thaler/research/pdf/smartjpe.pdf

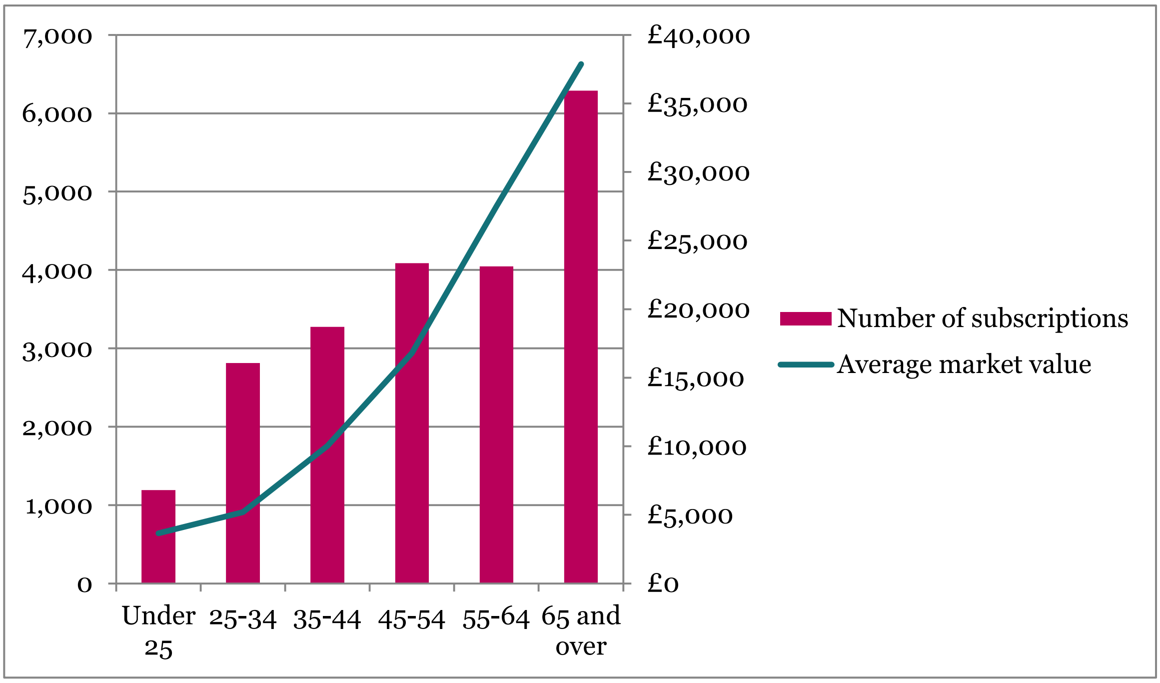
**FIGURE 2: MEDIAN WEALTH BY AGE GROUP**




Source: Wealth and Assets Survey Wave 4

Figure 3 shows ISA savings in the UK cut by age band and value. As can be seen, there is a significant age gradient in both the age of the subscriber and the amount they hold. Older people are both more likely to have an ISA than younger people and are more likely to have more money in it.

**FIGURE 3: ISA SAVINGS IN THE UK 2013/14 AGE OF ISA SUBSCRIBERS AND AVERAGE VALUE OF MARKET HOLDINGS**



Source: HMRC

With average ISA holdings in the UK (and remember, this is not the population, it is the section of the population with and ISA) being c. £37,000 in the 65 and over bracket, liquid savings in ISAs are not close to level of savings required to replace a significant proportion of pre-retirement income. It is unclear how far savings at these levels affect willingness to save in a pension.

It is not yet clear what the relationship between willingness to save and automatic enrolment is. It is possible that automatic enrolment will depress liquid savings levels overall and divert funds that would have gone into liquid savings into workplace pensions. Equally, it is also possible that automatic enrolment will drive up savings levels overall.

We will not understand the exact relationship between illiquid and liquid saving until the end of phasing. At that point, we will need to make an assessment about the impact of automatic enrolment on liquid savings but it will not be possible to make this assessment before then.

PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

## CHARGE CAP AND TRANSACTION COSTS

Workplace pensions should be better value but we do not think that an immediate reduction in the charge cap is the right way into the issue. The central issue with price regulation of any sort is the relationship between price and value. At the moment, we are considering further price regulation in the absence of a shared understanding of what value for money actually means in workplace pension provision. We have also not given existing initiatives enough time to work.

The deeper issue here is that the value to the end customer can be expressed roughly as contributions, plus investment growth minus costs and charges. This means that price is observed in the present but value is only judged in retrospect. Ultimately, this makes value hard to pin down in the present as all we have are judgements about what an appropriate investment strategy might be.

The general direction of regulatory policy in this area is towards greater encouragement of passive products and greater questioning of the value of some actively managed products. This has been paired in the interim report of the FCA's asset management market review with a scepticism about the real value provided by some agents in the value chain.

It is easy to see a consensus arising around greater use of beta strategies paired with value chains comprising fewer agents. That might be welcome and may provide better value for the end customer. Without an understanding of how products should evolve and the value they should be providing to the end customer, it is not easy to see at what level a maximum price should be set for a workplace pension.

This matters as it would be tempting to reduce the charge cap and then simply see what happens next. That could result in cheaper, better value products. Equally, it could result in products that are simply cheap and do not offer the same value to a consumer as a better crafted product.

There is the opportunity to use the 2017 review to discuss the relationship between price and value and to connect this to current thinking about the state of the market in asset management services. This would then give a firmer base on which to draw conclusions about the appropriate maximum price for a workplace pension.

### WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF LOWERING THE LEVEL OF THE DEFAULT FUND CHARGE CAP?

We believe that the charge cap has reduced incidences of poor practice but has achieved this at a cost. The cap has almost certainly narrowed the potential range of investments open to a scheme and accelerated a drive towards lower cost passive products.

In respect of some asset classes we are relaxed about some of the implications of this. Along with many others, we are not always persuaded as to the value added by actively managed approaches where similar performing passive products are available. Beta-only strategies are not viable in some asset classes and setting the charge cap at too low a level will reduce the ability of some schemes to diversify. This is particularly the case with illiquid asset classes which will need to be actively managed and which also may be intrinsically higher cost. Both infrastructure and real estate fall into this category.

The Association believes that further reduction in the charge cap will lead to consolidation in the market. Reducing the charge cap to 50 basis points is likely to lead to the removal of an unknown number of small and medium sized single employer occupational schemes.[12]

The Association sees consolidation as broadly desirable. Larger schemes offer economies of scale and, critically, no scale diseconomies. They are likely to be better governed and they will have increased access to higher quality investment opportunities. But we do not believe that increasing regulatory standards and waiting for consolidation to result is the right process. Rather, we believe that we need an open conversation about the direction of the market

This is not a disagreement about the direction of travel. Fewer, larger, better run schemes operating in a more efficient manner would almost certainly offer better value for members. Rather, it is a different perspective on the process the market should go through in order to reach that destination.

## WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF EXTENDING THE COVER OF THE CHARGE CAP TO INCLUDE SOME OR ALL TRANSACTION COSTS?

There are strong advantages and disadvantages to including transaction costs within the overall price to members. The advantages are, principally, transparency and potentially a reduction in the overall price paid by members for their pension. We do not regard the latter point as a given and see the potential for further regulation to increase prices. Pensions and other financial products are comparatively unusual in the way that charges are laid out up front but transaction costs manifest as performance drag. There is an attraction to full transparency.

Furthermore, lower prices are potentially attractive, as discussed above, provided that some form of consensus can be arrived at as regards value for money. Simply regulating price without an account of value could eventually lead to products that are cheap but of poor quality.

The disadvantages are more complex and harder to judge. Some asset classes are intrinsically higher cost than others. This is typically the case where the costs of actually directly owning an asset would need to be subsumed within the cap. This may have two effects. The first could be to inhibit investment in higher cost asset

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[12] Costs capital and charges (2017) unpublished research

classes. The second could be to allow investment in higher cost asset classes but in a more abstract manner.

Consider, for a moment, direct investment in windfarms. Actually owning windfarms comes with the requirement to operate the asset. That costs money, which will be accounted for in terms of costs and charges and those would need to apply to any charge cap. Substantially the same effect could be achieved, though, through investing in a hypothetical exchange traded fund comprised of wind-energy companies at a much lower superficial cost to the end investor. Yet the actual costs of carrying on the business would be reflected in the share prices of the companies within the ETF. The investment may be structured to reduce the appearance of costs and charges but there is no bucking the economic reality.

Finally, we are concerned that a cap including transaction costs could create an incentive not to transact even when to do so would clearly be in the interests of the end customer. If Government is interested in including transaction costs within the scope of the cap then it is worth noting that a hard cap is probably not feasible or desirable. A softer cap operating on a comply or explain basis could achieve the desired effect and also protect the consumer’s broader interests at the same time.