Institute
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of Actuaries

Review of Automatic Enrolment – Initial Questions

IFoA response to Department for Work and Pensions

20 March 2017

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Institute and Faculty of Actuaries

AE 2017 Review Team, Private Pensions Directorate
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20 March 2017

Dear Automatic Enrolment Review Team

IFoA response to 'Review of automatic enrolment – initial questions'

1. The IFoA welcomes DWP's wide-ranging review of automatic enrolment (AE). Undoubtedly, AE has been a great success in increasing the number of people saving into a pension scheme and we fully support the DWP in capitalising on this success. We consider the three priorities for the Review team and Advisory Group should be:
    - Any changes should not undermine the success to date, such as actions that could lead to an increase in opt-out rates.
    - However, opportunities remain for changes to AE that would remove complexity from the system and address concerns regarding fairness. Examples of this that are included in this review include the earnings trigger, as well as the definitions of non-eligible jobholders and entitled workers. Further examples outside of the remit of this review include the definition of qualifying earnings and whether the tax arrangement is 'net pay' or 'relief at source'. We suggest that the Review team and Advisory Group should also consider these areas of complexity.
    - Adequacy of retirement savings should be at the heart of this review, as it is essential that people save enough to meet all of their retirement income needs. Current contribution levels are unlikely to be sufficient for many individuals and there is a risk that people are unknowingly heading towards inadequate retirement provision. Adequacy could be improved by removing the age criteria, through employers rewarding saving over the minimum contribution rate in some way and introducing a method of auto-escalation akin to 'Save for Tomorrow'. We have elaborated on these points within our response.

2. Members working with DC schemes, as well as within advisory and guidance services have drafted this response.

Coverage

Question 1: Do the earnings trigger (£10,000 in 2017/18) and age criteria (22 to SPA) continue to bring the right people into automatic enrolment?

i. Is there a case for bringing individuals not currently eligible for automatic enrolment into scope, and on what grounds?

3. The employee contribution to a pension scheme remains the most tax efficient means of saving, and the employer contribution provides a significant boost to saving levels. Therefore, we believe it important that those on lower incomes do not risk losing out. We acknowledge that those in low paid jobs will likely have a number of competing demands on their income, and so saving for retirement may justifiably not be a priority. In fact, it may be detrimental to their overall financial situation if it results in a loss of means-tested State benefits. However, on balance, we consider it of greater importance that those on lower incomes have the opportunity to benefit from AE.

4. To strike a balance between the ability for those on lower incomes to save, with the risk of them losing out on tax relief and employer contributions, we recommend that once maximum contributions are payable across all employers, DWP considers reducing the earnings trigger. Crucially, this must be accompanied with information on State benefit entitlement.

5. We suggest that instead of the £10,000 earnings trigger, the trigger is set in line with the Lower Earnings Limit (LEL) for National Insurance (NI), which is currently £112 per week, or £5,824 per annum. This could have multiple benefits, including:
    - increasing the number of low earners who are eligible for AE, particularly those with multiple jobs, which individually would not make them eligible jobholders;
    - removing complexity for employers and employees, by aligning the NI and AE lower thresholds, as there would only be one lower earnings threshold across the two systems; and
    - allowing for better analysis of the most appropriate level for the earnings trigger, by allowing direct learnings from the significant amount of analysis that has been carried out on the most appropriate LEL for NI.

   We wish to reiterate that this should be accompanied by a targeted communication from the Government that both promotes the benefit of saving through a pension, whilst alerting these individuals to their right to opt-out, as well as the potential impact on any means-tested benefits.

6. We also recommend that DWP removes the age criteria for a number of reasons.
    - Firstly, we believe that regardless of age, entry in to the workforce is a crucial point for engaging individuals with saving towards their retirement.
    - Secondly, the sooner individuals begin to save for a pension, the greater opportunity there is for the savings to benefit from investment returns.
    - Finally, this would align with other Government's initiatives, such as the recruitment and retention of older workers as it would provide an additional financial incentive to continuing employment.

Question 2: 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?

7. As stated in our response to question one, we believe the lower age limit should be set at age 16, when an individual receives their NI number and the upper age limit be removed. We also consider that the earnings trigger should be set at £5,824 (the LEL for NI). This would mean there are just two categories:
    - eligible jobholders, aged 16 and over, earning at least £5,824 p.a.; and
    - non-eligible jobholders, aged 16 and over, earning less than £5,824.

Question 3: 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?

8. Our members' experience in providing guidance to micro-employers is that the biggest challenge to AE is yet to come. Therefore, to ensure that AE is the most appropriate method for increasing pension saving amongst the employees of micro-employers, we recommend close monitoring of the total number of employees auto-enrolled, as well as opt-out rates, from micro-employers.

Question 4: How can self-employed people be encouraged and enabled to save more for later life / for retirement?

9. AE nudges individuals towards saving by both harnessing inertia and incentivising through tax incentives and employer contributions. The current model for self-employed people lacks the ability to harness inertia, but it does have a tax incentive. If DWP wishes to increase levels of saving across self-employed people using tax incentives, one initiative could be a reframing of tax relief as a tax bonus. Individuals could be alerted to their potential 'tax bonuses' from their pension savings during the annual self-assessment. Should the Government want to introduce a system for self-employed individuals that harnesses inertia, it could collect additional NI contributions, which contribute towards the individual's pension. This would not be the equivalent of increasing NI contributions for the self-employed to raise tax revenue, as the ability to opt-out should be maintained.

Engagement

Question 5: What examples are there of effective communications and engagement tools that have delivered:

- **sustained workplace pension saving over the long term, and**
- **increased levels of savings resulting from changing contribution rates?**

10. We believe individual providers will be better placed to answer this question.

Question 6: 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?

11. Our members' experience is that there are a number of work and life events that offer effective touch points for pension savings, including:
    - Entering the workforce
    - Receiving a promotion / pay-rise
    - Changing job / career
    - Getting married or divorced
    - Having children and children leaving home
    - Finalising student loan or mortgage repayments
    - Receiving inheritance

12. We consider that the regular frequency of touch points throughout an individual's working life lends itself to a progressive approach to engagement, where the aim is to help individuals build their financial capability and take greater personal ownership over time. IFoA research has found that even when people start with low levels of knowledge and engagement this can

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be improved over time.[1] We consider that initially, engagement could help individuals to set saving goals, and then over time help them to assess their performance against these goals. Finally, if an individual is not on track to meet their goals, engagement could encourage them to take action.

13. In our 2016 report ‘Assessing adequacy of retirement income: a bottom-up approach’, we suggest that an outcomes-based approach to engagement could help to reinforce personal ownership and encourage saving.[2] An outcomes-based approach would entail individuals thinking about their retirement income needs, to create a holistic view of what their retirement might look like, dependent on how much income they will have. There are a number of ways that an outcomes-based approach might work; one approach that we set out in our report is the introduction of a Bronze, Silver and Gold rating. In this approach, the Bronze rating could link to a minimum income standard and the Silver and Gold ratings focus on improving financial resilience, as well as the setting of aspirational goals. This rating system would also enable individuals to set a series of goals, thereby making them both more manageable and more tangible.

14. In addition, this approach could help pension providers, guidance services and advisors to segment individuals so that they can target their communications effectively. For example, those individuals that are working towards the Bronze rating are likely to have lower financial wealth, which is likely to constrain the options available to them, mean that they have a low risk bearing capacity and is often indicative of lower financial capability. Whereas those in the fortunate position of being able to set Gold or aspirational goals will have greater financial wealth, have a greater range of retirement options available to them and a higher level of financial capability.

15. In this report, we recommend that a collective communication strategy would be needed to achieve this – across employers, the advisory, guidance and pensions industry, as well as by Government and regulators.

Question 7: What are the challenges and barriers to sustained or timely engagement for different cohorts and individuals, and how can they be overcome?

16. In order to assess which cohorts are engaging with pension saving the IFoA conducted a survey on attitudes to retirement saving. We asked respondents about the steps they had taken to prepare for retirement. The range of potential responses included paying for financial advice, reading free guidance provided by the Government or their employer, as well as talking to friends and relatives in a more informal setting.[3]

17. Overall, a worrying 42% of respondents said they had done nothing to prepare for their retirement. This number decreased gradually as respondents got older, but even amongst the over 55s, a third of respondents (33%) had done nothing to prepare for their retirement. This trend is most worrying amongst females. Whilst there was a sharp decrease in unpreparedness amongst males in the age 55 and over category, from 39% to 23% of respondents, the percentage of females that have not done anything to prepare for their retirement remained just above 40%.

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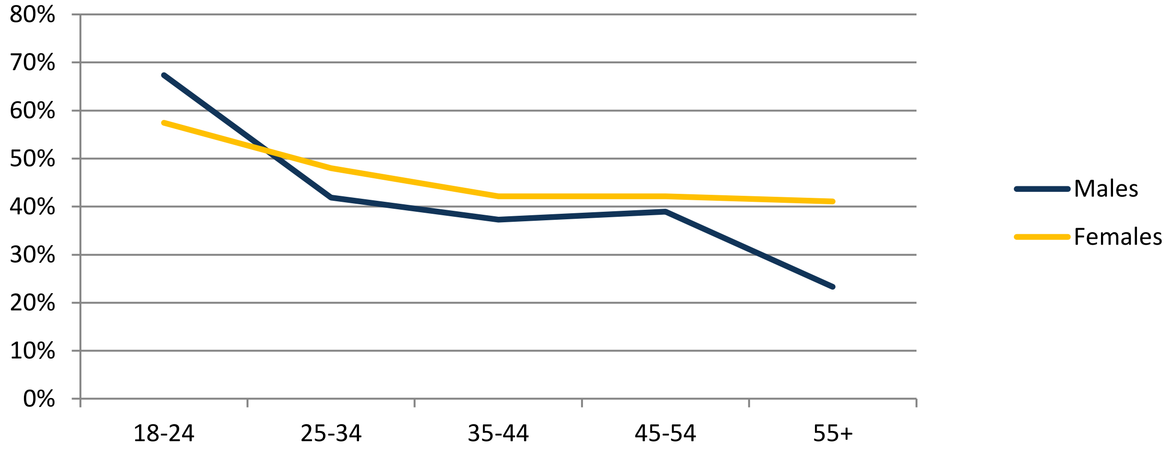
[1] IFoA (2012) *Transforming consumer information: a discussion paper* [Authors: Ritchie, A. *et al.*] [Available online: https://www.actuaries.org.uk/documents/transforming-consumer-information-discussion-paper]

[2] IFoA (2016) *Assessing adequacy of retirement income: a bottom-up approach* [Available online: https://www.actuaries.org.uk/documents/assessing-adequacy-retirement-income-bottom-approach]

[3] The full results of this survey will be published in spring / summer 2017

Figure 1: Percentage of respondents that have not done anything to prepare for their retirement by age and gender



18. Of those individuals who had made some effort to plan for their retirement, most respondents had taken free sources of guidance, with:
    - 23% of respondents saying they had used the internet or other free online sources;
    - 24% had read information provided by their employer; and
    - 26% had read information from their pension provider.

19. Interestingly, the most frequent response for those aged 25 to 44 was information provided by their employer, with information provided by their pension provider being most frequent amongst those aged 45 and over. This demonstrates the crucial role of employers, particularly in the earlier stages of a person's working life, and before they may believe the information from their pension provider to be relevant to them.

20. An average of just 6% of respondents had paid for financial advice. Perhaps unsurprisingly, those with higher earnings were more likely to have taken advice. Of those salaries below £15,000, less than 1% had taken advice. This average increased to 6% and was relatively consistent for those earning between £15,000 and £70,000. There was a marked increase in the number of people taking advice when salaries increased to over £80,000, with an average of one quarter of respondents having taken financial advice, this percentage was as high as 38% for those earning over £150,000.

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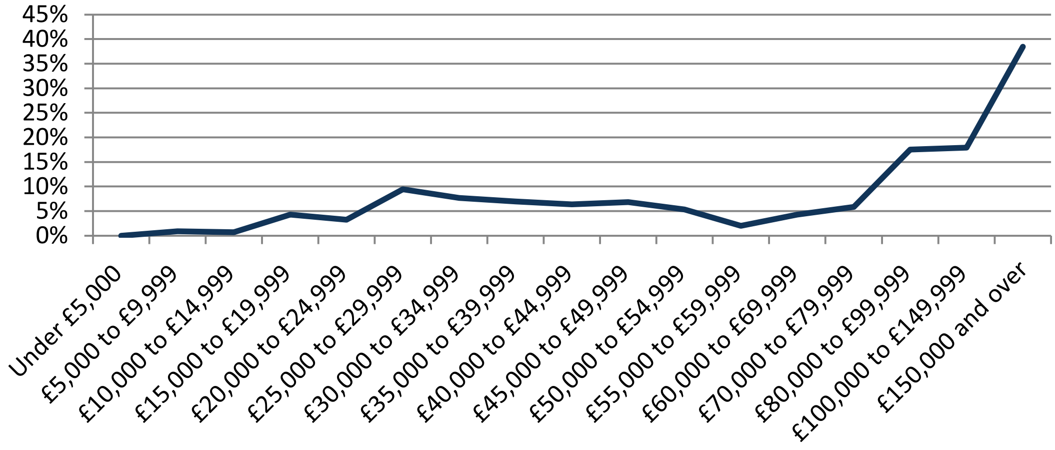
Figure 2: Percentage of respondents that had paid for financial advice by gross household income



21. The findings provide evidence that a 'one-size-fits-all' approach is not necessarily appropriate for engaging savers. Our survey found that gender, age and household income were all important factors in determining whether an individual engaged with their retirement saving and whether they were more reliant on information from their employer, pension provider, other free sources of information or financial advice. Therefore, there is a role for employers, pension providers, guidance services and advisors in engaging scheme members with their pension saving.

22. However, whilst there are lessons to be learnt that could foster greater engagement, the success of automatic enrolment has largely been attributed to inertia. Initial market findings have been that many auto-enrolled individuals have not engaged with their pension saving and remain in the default fund and on default levels of contributions. It is therefore important that pension providers continue to seek ways of harnessing inherent behavioural biases that have lead to most individuals remaining with default options.

23. We believe defaults, which harness behavioural biases, could help to drive up levels of saving if contribution levels were increased gradually over time. Importantly we consider such an approach could be designed in a way that would not jeopardise the current low proportion of individuals opting out. We are one of a number of sponsors of a current Pensions Policy Institute series on the behavioural barriers and biases for consumer engagement, which we would strongly recommend DWP refers to in its review.[4]

Question 8: What are individual attitudes to workplace pension saving and what influences those attitudes?

24. Please see our response to question seven.

Contributions

Question 9: 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?

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[4] Pensions Policy Institute (2016) *Consumer engagement: barriers and biases* [Available online: http://www.pensionspolicyinstitute.org.uk/publications/reports/consumer-engagement-barriers-and-biases]

25. In respect of individuals, as stated in our response to question seven, the role of defaults will be essential in harnessing inertia to increase contribution rates amongst unengaged savers. The harnessing of inertia could be further enhanced by implementing a vehicle for auto-escalation. 'Save More Tomorrow', which has been successful in the USA, commits individuals to allocate an increased portion of future salary increases towards retirement savings.[5] We believe a similar system could be helpful here in the UK as this policy intervention also capitalises on inherent behavioural biases, without the need for constraints on market participants' freedom and choice. Further thought would be needed on how this might work in the context of AE when an individual changes jobs. Should the Review team and Advisory Group consider such an option, we would like to offer our members' expertise to help consider what increases might be appropriate over the lifetime within DC arrangements. Our members have significant experience of helping employers design contribution scales based on target outcomes.

26. We consider that an outcomes based approach can improve engagement. Once there is engagement, we believe than an outcomes-based approach could increase contribution rates by facilitating the setting of manageable and tangible goals. We consider that the setting of manageable and tangible goals would make the pay-off between the effort of saving and the reward of having more income in retirement more obvious, thereby encouraging saving. Our research found that where individuals believed their efforts to be worthwhile, i.e. where the potential reward outweighs the effort, focusing on outcomes improves engagement with financial decision-making.[6]

27. In respect of employers, the key barriers are the time and cost of implementing AE and the ongoing cost of providing pensions for their employees. This can be particularly challenging for micro-employers where there is no prior expertise for pension provision. This could lead to employers taking actions that either discourage pension saving, or which would make their employees ineligible for AE. We appreciate that the Government has taken significant steps to help micro-employers through The Pensions Regulator and National Employment Savings Trust. It will be important that the Regulator and Government closely monitor the enrolment of micro-employers to ensure that the process is as intuitive and simple as possible.

Question 10: Is there scope for a more flexible approach to contribution rates to reflect an individual's life and employment journey?

28. We strongly support a flexible, lifetime approach, which seeks to align each individual's life and employment journey with his or her contribution rates. An example of this, which we reiterate the UK could consider adopting, is the 'Save for Tomorrow' programme that is operating in the US.

Question 11: 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?

[5] Thaler, R. & Bernartzi, S. (2003) *Save More Tomorrow: Using Behavioural Economics to Increase Employee Saving*
[6] IFoA (2014) *Outcomes and Defined Ambition* [Boulding, A. *et al.*] [Available online: https://www.actuaries.org.uk/documents/outcomes-and-defined-ambition]

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29. By the time the contribution level has reached 8%, the ratio of contribution between the employer and employee will be 3:5. Our members' experience is that most larger occupational pension schemes have a ratio of at least 1:1, with many employers offering a greater proportion of the contribution. One example is through the Pension Quality Mark, a standard recognising high quality defined contribution (DC) pension schemes, where total contributions need to be at least 10%, with a minimum of 6% coming from the employer. As the AE model has a reduced ratio of contribution from the employer, we consider that individuals who opt to save greater amounts than the minimum could be rewarded with greater employer contributions. We acknowledge that this could mean significant additional costs for employers and so we would suggest that this is a medium-term aim.

Question 12: 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?

30. Owing to employer contributions supplementing individual contributions, we believe pensions do and should remain an important part of an individual's retirement planning. However, there are numerous ways of saving for retirement, with ISA-style products and housing equity being particularly popular. It is important that saving into a pension is viewed within an individual's overall retirement savings and the role of the employer is crucial to ensuring that pensions continue to be valued by employees.

The wider review activity

Question 13: What are the advantages and disadvantages of lowering the level of the default fund charge cap?

31. Whilst it is highly likely that consumers would welcome lower charges, lower charges do not necessarily guarantee the best outcome. Rather than a race to the bottom, we believe it is important that charges should represent value for money when considered within the context of good governance and an appropriate investment strategy.

Question 14: What are the advantages and disadvantages of extending the cover of the charge cap to include some or all transaction costs?

32. We consider that the inclusion of all transaction costs within the cap would have the advantage of allowing members to make an easier comparison of costs between funds. The current perceived disadvantage is being unable to obtain the relevant information on transaction costs, but we consider this will, in time, be largely overcome through the recent standardised transaction costs disclosure proposals from the FCA.

33. A further point we would like to note is that reducing the level of the default fund charge cap would be even less desirable if the cap was extended to include transaction costs.

Should you wish to discuss our response in further detail please contact Rebecca Deegan, Policy Manager (rebecca.deegan@actuaries.org.uk / 0207 632 2125) in the first instance.

Yours sincerely,

C. Wil

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