

Personal accounts: a new way to save

December 2006





# Personal accounts: a new way to save

Presented to Parliament by  
the Secretary of State for Work and Pensions  
by Command of Her Majesty  
December 2006

**© Crown Copyright 2006**

The text in this document (excluding the Royal Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified. Any enquiries relating to the copyright in this document should be addressed to The Licensing Division, HMSO, St Clements House, 2-16 Colegate, Norwich, NR3 1BQ. Fax: 01603 723000 or e-mail: [licensing@cabnet-office.x.gsi.gov.uk](mailto:licensing@cabnet-office.x.gsi.gov.uk)

# Contents

Prime Minister’s Foreword .....	5
Foreword .....	7
Summary .....	9
<b>Chapter 1: Individuals and automatic enrolment .....</b>	<b>45</b>
The target group .....	48
Automatic enrolment.....	50
How automatic enrolment will work in practice .....	51
Who will be automatically enrolled .....	53
Conclusion .....	57
Questions for consultation .....	57
<b>Chapter 2: Choosing the personal accounts model .....</b>	<b>59</b>
The Pensions Commission proposals .....	61
Reaction to the Pensions Commission .....	62
May 2006 White Paper proposals .....	62
Understanding the various approaches .....	65
Evaluating the different approaches .....	67
Which model? .....	68
Maximising participation – providing individuals with the appropriate choice.....	68
Minimising charges in the scheme .....	72
Conclusion .....	76

Chapter 3: Delivering personal accounts .....	77
Organisation structure .....	80
Creating personal accounts.....	81
The personal accounts board .....	83
Member representation .....	85
Information .....	86
Conclusion .....	88
Questions for consultation .....	88
Chapter 4: Charges and financing .....	89
Importance of low charges .....	91
Would an annual management charge of 0.3 per cent be achievable?.....	93
Financing personal accounts .....	96
Membership charge structures .....	96
Conclusion .....	97
Questions for consultation .....	98
Chapter 5: Investment and accessing savings.....	99
What level of choice will be offered in personal accounts?.....	102
The default fund.....	106
Who should be responsible for different aspects of investment in personal accounts? .....	107
Accessing pension savings (decumulation) .....	108
Conclusion .....	109
Chapter 6: Employers and private pension reform.....	111
The exemption process for pension schemes .....	116
Simple tests .....	116
Exemption for occupational defined benefit schemes .....	117
Exemption for occupational defined contribution schemes.....	118
‘Non-occupational’ workplace pension provision.....	119
Waiting periods .....	120
Waiting periods for exempt schemes.....	121

Automatic re-enrolment for exempt schemes .....	122
Helping employers adjust to the new arrangements .....	123
A light-touch compliance regime .....	124
Conclusion .....	127
Questions for consultation .....	128
<b>Chapter 7: Personal accounts and existing pension provision .....</b>	<b>131</b>
Addressing the problem of undersaving .....	133
Opportunities for the financial services industry .....	135
Supporting existing employer-sponsored provision .....	135
Targeting the personal accounts scheme effectively .....	138
Personal accounts transfer policy .....	139
An annual limit on personal account contributions .....	140
Stakeholder pensions .....	142
Encouraging savings in the run-up to implementation from 2012 ...	143
Conclusion .....	144
Question for consultation .....	144
<b>Chapter 8: Next steps .....</b>	<b>145</b>
Commercial and procurement strategies .....	147
Legislation .....	148
Further research and analysis .....	148
Consultation arrangements .....	149
How to respond .....	152
Confidentiality .....	153
Feedback .....	154
<b>Annex 1: Response to the House of Commons Work and Pensions Select Committee Report: recommendations and conclusions .....</b>	<b>155</b>
<b>Glossary .....</b>	<b>165</b>





## Prime Minister's Foreword



There has long been recognition of the need to overhaul our pension system for a society where we all live longer. But whilst significant reforms have been introduced since 1997, a lasting settlement needs to be built on the foundations of a strong national consensus.

This is why we set up the Pensions Commission to find how our society can provide an affordable and sustainable pensions system for future generations. Its report, published a year ago, proposed the biggest shake-up of both state and private pensions seen for half a century. It involved, as expected, difficult decisions for everyone – for Government,

business, the pensions industry and individuals. But the report also set out in stark terms the consequences of continuing to duck the challenge.

Over the last year, we have worked hard to forge a national consensus around these recommendations, culminating in the White Paper published in May. It set out proposals for a modernised state pension system to provide a solid foundation of support in retirement. Matched by a gradual increase in the State Pension age to reflect increasing life expectancy, it will provide more generous State Pensions and fairer treatment for women and carers. These measures are in the Pensions Bill currently going through Parliament.

Today we build on the Commission's proposals for reforms to promote private savings. A new system of personal accounts will extend the benefits of low-cost saving to those without access to a good occupational pension. For the first time there will be a matching compulsory employer contribution. We'll make sure individuals do not miss out by automatically enrolling them into the scheme.

These are radical reforms. But they are necessary to put in place a sustainable, affordable and trusted pensions system which will meet the needs of the country and future generations by helping security and dignity for all in retirement.

The Rt Hon Tony Blair MP

December 2006



## Foreword



Our White Paper, *Security in retirement: towards a new pensions system*, set out a new structure for the long-term future of pensions in the UK. A simpler and more generous State Pension paid for by a higher State Pension age that will ensure the system remains affordable and provide a solid foundation on which to save. More generous qualifying rules will, for the first time, properly recognise the social contributions people make – and in doing so deliver fairer outcomes, especially for women and carers. And, crucially, a new system of personal accounts that will give future savers an unprecedented opportunity to take personal

responsibility for building private savings.

We estimate that around 7 million people are not saving enough for their retirement. Many are from low-income households and have been poorly served by existing pension products. Inertia and short-termism – combined with the difficulty of making the right choice – stop people from making any choice at all, while pension providers find they cannot profitably supply what is needed.

The proposals in this White Paper seek to put this right. Combined with mandatory matching employer contributions, tax relief and automatic enrolment, the new personal accounts will radically improve access to affordable, low-cost pension saving for many on moderate to low incomes who do not currently save in a private pension.

Our goal is to give people a good expectation that if they contribute to the state system for most of their career, they will be better off for having saved. Between 6 and 10 million people could eventually save into personal accounts. By retirement their pension funds could be worth up to around 25 per cent more because of lower charges – and could generate an additional £4–5 billion of new saving, equivalent to around half a per cent of GDP.

I am grateful to everyone who has contributed to the consultation process over the period since May. The proposals in this White Paper are ambitious – rightly, because the challenges we face are pressing and substantial. But we believe that personal accounts can help us meet these challenges and in doing so, embed a new pensions savings culture at the heart of a sustainable, affordable and trusted pensions settlement.

A handwritten signature in black ink, appearing to read 'John Hutton'.

The Rt Hon John Hutton MP





## Executive summary



# Personal accounts: simplifying pensions, enabling choice

## Our proposals

We estimate that around seven million people are currently undersaving for retirement. The Government is introducing radical reform to the private pensions system to help simplify pensions and overcome the obstacles to saving. Our main proposals are:

- all eligible employees will be automatically enrolled into either a personal account or an employer-sponsored scheme. Employees will contribute a minimum of 4 per cent, matched by a minimum 3 per cent employer contribution and around 1 per cent in the form of normal tax relief from the State. This will overcome the inertia and short-termism that characterise attitudes to saving;
- a new scheme of low cost personal accounts based on the approach outlined by the Pensions Commission. This approach will maximise coverage among our target group, minimising charges and delivery risk;
- a new national minimum employer contribution to improve incentives to save and increase pension participation;
- a simple choice for members, which we expect to include ethical and branded funds for those who want them, and a default fund for those who do not want to make a choice;
- an innovative approach to delivering the scheme using a delivery authority, staffed by individuals with expertise in business and financial services;
- a governance scheme with operational independence, whose duty to consult members and act in their interests will insulate it from external pressures; and
- a set of policies to ensure that personal accounts will complement, rather than compete with, existing high quality pension provision, including no transfers in and out of personal accounts and a maximum annual contribution of at least £5,000.

## Section 1: The need for reform

1. Pensions are complicated, but the idea behind them is simple – save now to spend later. Yet too many people find it difficult to save what they need for retirement. Estimates suggest around 7 million people are not saving enough for retirement.<sup>1</sup> Only 40 per cent of those who have not yet retired are saving for their retirement at all – yet 80 per cent say that they will need more than a State Pension to live on.<sup>2</sup>
2. Although parts of the pensions market work very well, it is failing for people on average and low incomes who do not have access to a company scheme. It is difficult for customers in this group to find the right kind of pension product for their circumstances and pension providers cannot profitably supply what is needed.

### Lack of demand

“I don’t really know what goes on in how to set up a pension or anything like that, but I know that you do it at the age of around 40/50. I’ve never actually thought about doing it, it’s not something I talk about with friends or anything.”

(Not saving, 18–21, £10–20k)<sup>3</sup>

“You think about it and think I’ll deal with it another time and then that other time don’t come.”

(Not saving, 31–65, under £25k)<sup>4</sup>

3. Consumer demand for pensions is lower than would be needed to fund the retirement people expect. Behavioural economics suggests that there are two main reasons for this:<sup>5</sup>
  - **choice paralysis** – people know that choosing a pension is an important decision, but the difficulty of making the **right** choice often stops people making **any** choice; and
  - **living for today** – it is easier to make decisions about today, than about what will happen in 40 years. Many do not want to think about getting older, let alone how to save sufficient money for their retirement.

<sup>1</sup> Estimates of the current level of undersaving for retirement are difficult to construct because they rely on different data sources, and there are measurement difficulties. The current DWP estimate is based on analysis by the Institute for Fiscal Studies (Banks J, Emmerson C, Oldfield Z and Tetlow G, 2005, *Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England*. Institute for Fiscal Studies).

<sup>2</sup> Atkinson A, McKay S, Kempson E and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, Financial Services Authority Consumer Research Report, 47.

<sup>3</sup> Green E and White C, 2005, *Effective means of conveying messages about pensions and saving for retirement*, DWP Research Report No 239.

<sup>4</sup> Green E and White C, 2005, *Effective means of conveying messages about pensions and saving for retirement*, DWP Research Report No 239.

<sup>5</sup> Chapter 2 sets out further details about behavioural economics.



4. As well as being insufficient, the demand for pensions is often ineffective. Consumers on moderate incomes typically do not understand pension products well<sup>6</sup>, find it hard to make comparisons, and rarely switch providers.<sup>7</sup> Research by Oxera for the Association of British Insurers (ABI) found that under 4 per cent of personal pension customers and just over 2 per cent of stakeholder pension customers switch; this is lower than the switching rate observed in sectors such as fixed and mobile telephones, mortgages, car insurance, gas or electricity, and only slightly higher than that observed in banking. The result is that customers do not impose effective pressure on providers to reduce cost or improve quality.
5. This is not true of the successful parts of the pension market. In occupational pension schemes, for example, trustees act as informed customers (supported by professional advice) and are able to exert more effective pressure on providers. And for the better off buying personal pensions (including stakeholder pensions), there is the independent financial advice network to help them.

### Supply gap

6. The Pensions Commission's research suggests that it costs around £800 to sell a personal pension to someone working for a medium-sized employer.<sup>8</sup> However, consumers often do not persist in making contributions. More than a third of all personal pension contracts lapse<sup>9</sup> after four years and this percentage is increasing.<sup>10</sup> Assuming present persistency rates continue then, of personal pensions started today, only 40 per cent will still be receiving contributions in ten years time.<sup>11</sup>
7. The combination of high up-front costs and non-persistency means that providers have a relatively short period in which to recoup the large set-up costs. This has two implications:
  - firstly, it leads to **relatively high charges**. Few personal pensions (sold on an individual basis) have charges significantly below the stakeholder pension cap of 1.5 per cent of funds under management.<sup>12</sup> This compares to many occupational pensions which charge 0.3–0.5 per cent; and

<sup>6</sup> Atkinson A, McKay S, Kempson E and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, FSA Consumer Research Report No 47.

<sup>7</sup> Oxera, 2006, *How to evaluate alternative proposals for personal account pensions: An economic framework to compare the NPSS and Industry model*, commissioned by the ABI.

<sup>8</sup> Pensions Commission, 2004, *A new pension settlement for the twenty-first century: The first report of the Pensions Commission*, TSO.

<sup>9</sup> Lapse – either no new contributions are made or the funds are transferred to another provider

<sup>10</sup> Pensions Commission, 2004, *A new pension settlement for the twenty-first century: The first report of the Pensions Commission*, TSO.

<sup>11</sup> Pensions Commission, 2005, *A new pension settlement for the twenty-first century: The second report of the Pensions Commission*, TSO.

<sup>12</sup> Falling to 1 per cent after ten years.

- secondly, it means that it is **not economic for providers to sell individual personal pensions** to consumers on low and moderate incomes. The high costs of advice in relation to the low level of funds under management result in disproportionately high charges. High earners, who will have more funds in the scheme generating higher revenue, or those working for large employers – where economies of scale are easier to achieve – are more attractive.
8. In addition, there have been problems such as mis-selling and scheme failures in the supply of pensions which have dented trust in the market. In both cases, assistance was put in place to rebuild confidence. For the future, the Pension Protection Fund (PPF) has been introduced to act as a safety net for today's occupational pension schemes.

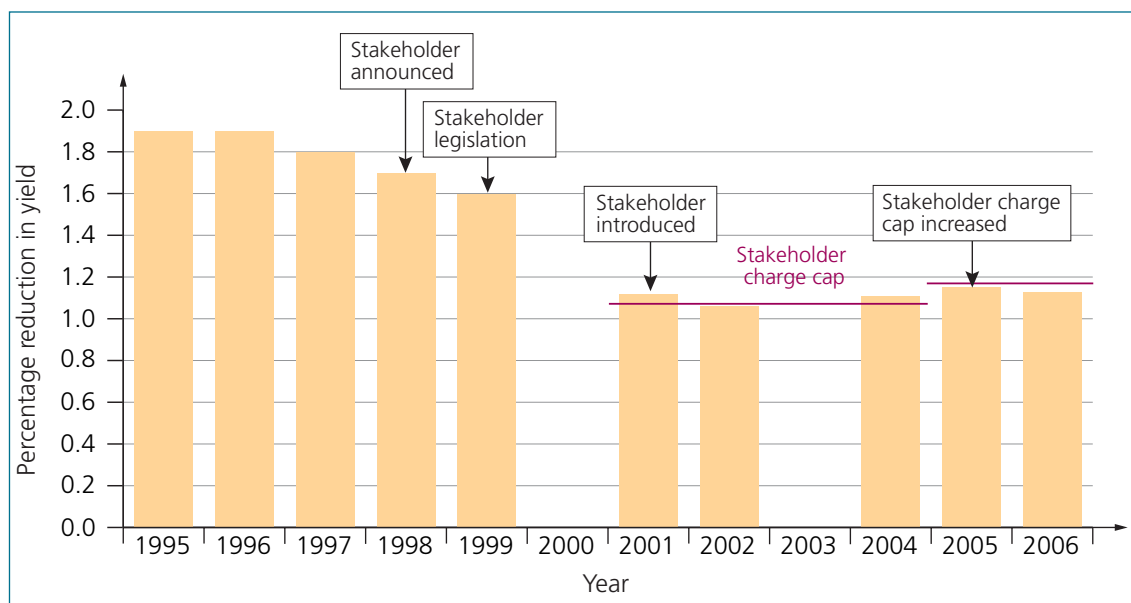
### Ineffective competition

9. It is clear that competition alone is not sufficient to deliver simple, low cost, long-term savings products for those on average incomes without access to a good company pension. A well functioning market should produce improved outcomes for individuals, such as better service, reduced charges and innovative products. But the Sandler review<sup>13</sup> found that this did not happen in the pension market, concluding that:
- "...competitive forces do not always work effectively to deliver value. Charges for near-identical products can differ widely."; and
  - "It is noteworthy that, in contrast to many other industries, the unit costs of the life industry have risen significantly in recent years."
10. The impact of fees and charges on the investment return in personal pensions has declined significantly since the mid-1990s, from around 1.9 per cent in 1995 to around 1.1 per cent in 2002 as shown in Figure 1. However, this may have been driven by regulation rather than competition. The Pensions Commission reported<sup>14</sup> that the decline: "...to a significant extent reflects the introduction of the stakeholder pension charge cap, set at 1 per cent annual management charge (AMC)...in 2001, and regulatory guidance from the Financial Services Authority which has meant that financial advisers could not recommend products with charges significantly above this price cap."

<sup>13</sup> *The Sandler Review of Medium and Long-term Retail Investment*, July 2002.

<sup>14</sup> Pensions Commission, 2004, *Pensions: Challenges and Choices, The First Report of the Pensions Commission October 2004*, see Appendix C.

Figure 1: Impact of regulation on charges over time

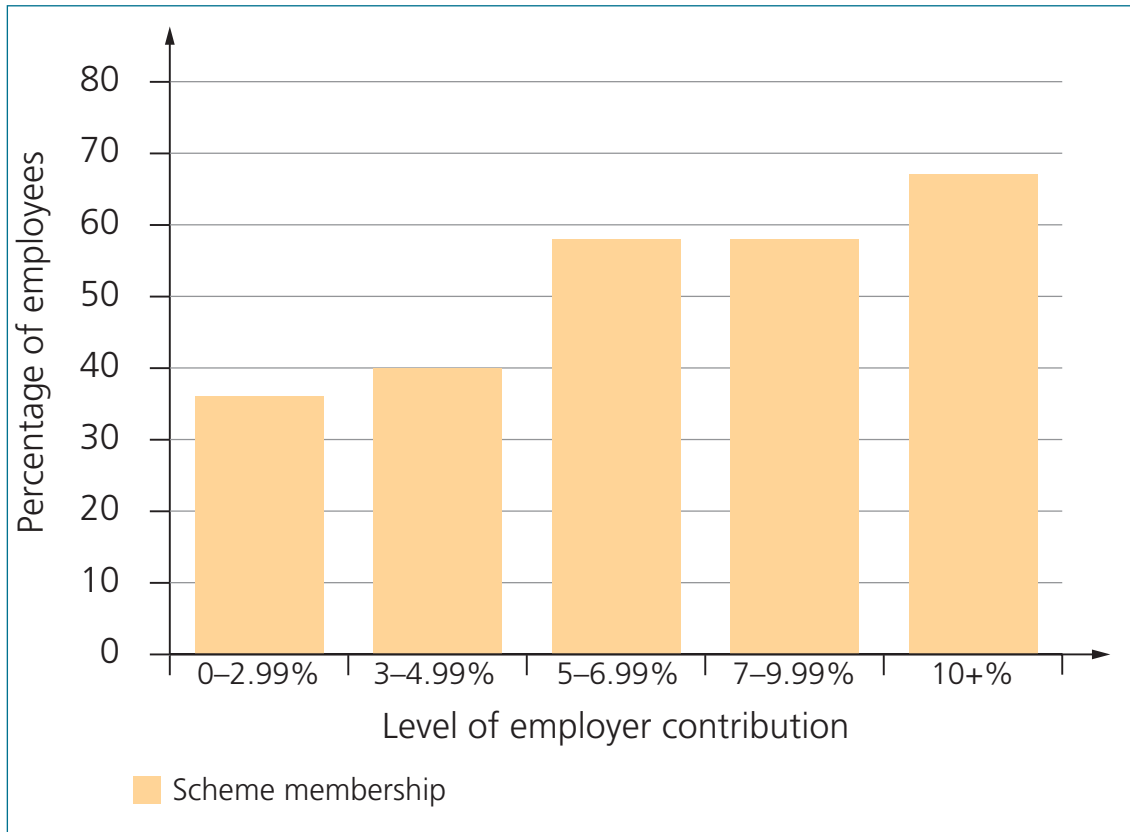


Source: FSA disclosure reports and comparative tables

### Scale of the challenge

- Where the problems of low demand and supply do not apply, the pensions market works very well. Company pensions achieve much lower charges. People who work for a company with a good-quality pension scheme are more likely to be saving for a pension than those who are not in that position. As can be seen in Figure 2, the higher the level of employer contribution in employer-sponsored provision, the higher the participation rate.

Figure 2: Existing pension provision: scheme membership by contribution levels

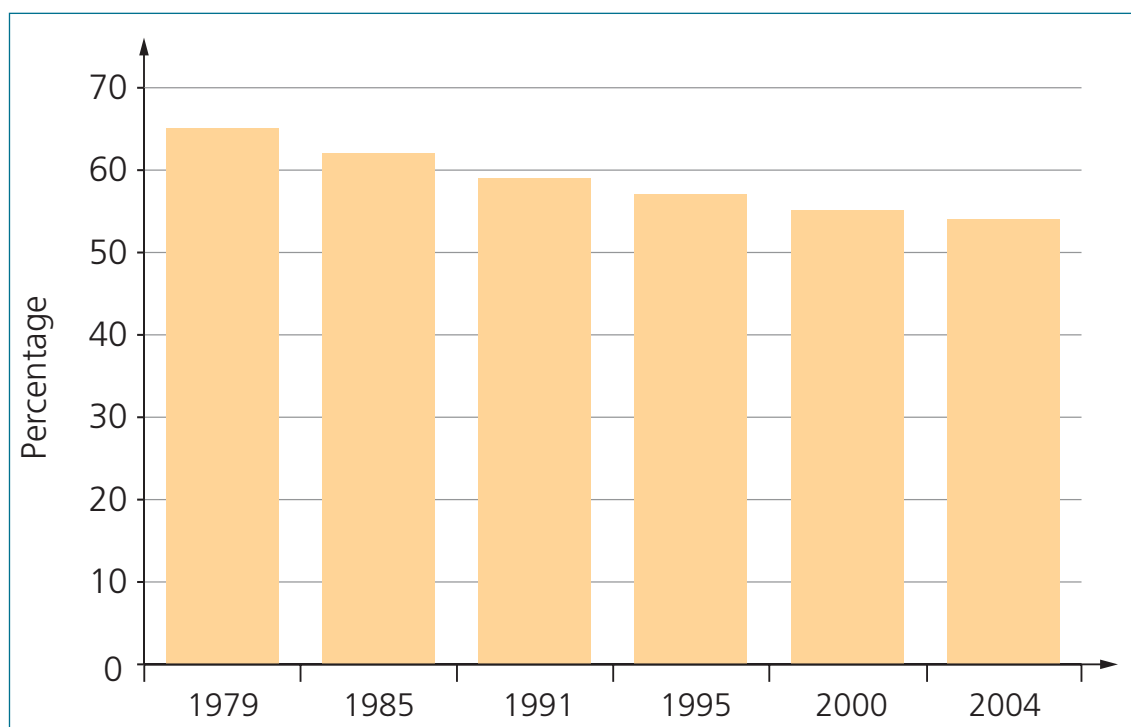


Source: DWP analysis based on *Employers' Pension Provision Survey 2005*, *Small and Medium-sized Enterprise (SME) Statistics 2005* and *Annual Survey of Hours and Earnings 2005*

12. Where employers are engaged in pension provision, and employees are participating, employees are able to build up good pensions. However, as identified by the Employer Taskforce on Pensions<sup>15</sup>, there has been a retreat by employers from providing pensions and the Pensions Commission concluded that this trend was unlikely to be reversed.

<sup>15</sup> ETF Report to the Secretary of State for Work and Pensions. Published December 2004 [www.employertaskforce.org.uk](http://www.employertaskforce.org.uk)

**Figure 3: Membership of current employer's pension scheme for full-time employees 1979 to 2004**



Source: General Household Survey, GB

Notes: Full-time employees aged 16 and over. Prior to 1985 full-time students are excluded. Later figures include full-time students who were working but exclude those on Government schemes. Figures include a few people who were not sure if they were in a pension scheme but thought it was possible. Data from 2000 onwards are weighted.

13. Overall participation in occupational schemes is falling as illustrated in Figure 3. In 1979, 65 per cent of employees were members of their current employer's pension scheme compared to 57 per cent in 1995, and around 54 per cent in 2004.<sup>16</sup> The percentage of private sector employees participating in occupational pensions fell from around 40 per cent in 1991 to around 25 per cent in 2005.<sup>17</sup>

<sup>16</sup> General Household Survey, GB.

<sup>17</sup> Analysis based on the Government Actuary's Department's Occupational pension schemes survey and Office for National Statistics employment data.

14. The Government wants to support employers providing pension schemes. The combination of problems with both demand and supply, and a lack of effective competition within some sectors of the pensions market, mean that a voluntary approach to private saving is unlikely to be sufficient to tackle the current barriers that prevent people from saving optimally. This trend is particularly pronounced amongst young people, with fewer of those in their 20s and 30s saving than even five years ago.<sup>18</sup>
15. The Pensions Commission found that between 9.6 and 12 million people were undersaving based on the benchmarks they set out. Further analysis by the DWP has refined that estimate to around 7 million people.<sup>19</sup>
16. Without action, millions of today's workers could retire without having built up sufficient pension savings to fund the lifestyle they are expecting. The Commission concluded that a voluntary approach to private pension saving would not be enough to close that gap.
17. Automatic enrolment into existing stakeholder schemes would go some way to dealing with the lack of demand in the pensions market for our target group, by overcoming the inertia that leads many individuals not to make a decision to save. It would also increase the number of savers and the amount of savings in stakeholder schemes. However, automatic enrolment into stakeholder pensions would not help to increase the persistency of saving, because members would not automatically stay in the same pension when they moved jobs. This could also lead to increased burdens on employers. Our work, and that of the Pensions Commission, suggests that this would not lead to a significant reduction in charges for our target group and would therefore not represent good value.

<sup>18</sup> *Family Resources Survey*.

<sup>19</sup> Estimates of the current level of undersaving for retirement are difficult to construct due to: difficulties identifying appropriate saving targets; uncertainties about which kinds of wealth and asset to take into account; difficulties projecting individuals' future saving and working patterns, particularly around choice of retirement age; reliance on inadequate data; and reliance on a range of other uncertain assumptions, including the impact of future macro-economic developments. Consequently, such estimates should be treated cautiously. The current Department for Work and Pensions (DWP) estimate draws on analysis by the Institute for Fiscal Studies (Banks J, Emmerson C, Oldfield Z and Tetlow G, 2005, *Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England*, IFS). The May 2006 White Paper (*Security in retirement: towards a new pensions system*) sets out some of these issues in more detail.

18. None of these problems are new but they could have more serious consequences as people live longer and fewer children are born. Today there are almost four working age people for each pensioner.<sup>20</sup> By 2050, without action on the State Pension age, this would have fallen to two working age people for each pensioner.<sup>21</sup>
19. Without an increase in private saving, future generations could retire poorer than today's pensioners, and poorer than they expect to be. This could lead to pressure to increase State Pensions, but the demographic trends would make this hard to fund. If there were only two working age people for each pensioner, the cost of dealing with the consequences of a failure to save would be very high, and fall disproportionately on future generations.

## Section 2: Our approach – fairness and empowerment

20. Since 1997, the Government's goal has been to provide security in retirement for all pensioners. On coming to office the priority was to tackle the legacy of pensioner poverty. Thirty per cent of pensioners were below the poverty line and those on means-tested benefits were expected to live on only £69 a week.
21. The Government introduced the Minimum Income Guarantee for pensioners, now part of Pension Credit. This has raised the minimum income that pensioners are expected to live on from £69 a week in 1997 to over £114 a week today. Pensioners have also benefited from the Winter Fuel Payments, basic State Pension rising 9 per cent faster than inflation, higher age-related tax allowances and free TV licences for the over 75s.
22. We now spend over £10 billion a year (nearly 1 per cent of national income) more on pensioners than we would have done if we had simply continued the policies inherited in 1997. The amount spent on pensioners has gone up faster than earnings. As a result, pensioners are, on average, £26 a week better off, with the figure for the poorest pensioners being £38 a week in real terms. More than 2 million pensioners have been lifted out of absolute poverty and 1 million out of relative poverty. A pensioner in Britain today is no more likely to be in poverty than anyone else.
23. In addition to tackling the immediate priority of pensioner poverty, the Government has started to reform the pensions system to meet the pressures of an ageing society.

<sup>20</sup> Working age is defined as those aged 20 to 64 for both men and women. Pensioners are defined as those aged 65 or over for both men and women.

<sup>21</sup> Analysis based on the Government Actuary's Department's 2004 population projections. The proposed changes to State Pension age will increase this ratio from two to one, to three to one.

### Helping more people to save

24. The State Second Pension was introduced in 2002, providing greater support for lower earners and some carers who did not qualify for its predecessor, the State Earnings Related Pension Scheme (SERPS). As a result, some 4 million people now have the chance to build up a decent second pension for the first time.
25. The Government introduced stakeholder pensions in April 2001 to provide access to good value and flexible personal pensions. Employers with five or more employees are required to provide access to a stakeholder pension scheme unless they already offer an occupational scheme to all staff, or make employer contributions of at least 3 per cent of basic earnings into personal pensions. The regulation of charges has led to a significant reduction in average charges, increasing the pension fund for an average earner by approximately 20 per cent.<sup>22</sup> Stakeholder pensions were a first step to extending access to private pensions – but coverage is still not universal.
26. The Government has also acted to increase the security of private pension saving, in the light of failed company pension schemes. Whilst we cannot change the past, we can learn lessons for the future, and help those who are in greatest need. The Financial Assistance Scheme will provide over £2 billion in cash terms to help those up to 15 years from retirement who lost out before the Pensions Protection Fund (PPF) was established. For the future, the PPF creates a safety net for employees saving today in company pensions. Over 14 million<sup>23</sup> members of salary-related pension schemes now know that they will receive compensation if their employer becomes insolvent and the pension scheme is under-funded.
27. The new Pensions Regulator is also helping to protect members' benefits and promote good administration of work-based pension schemes. The Regulator has wide powers to investigate schemes and take action where necessary, and takes a proactive, risk-focused approach to regulation.
28. In April 2006, the many sets of rules governing the taxation of pensions were replaced by a single universal regime for tax-advantaged pension saving. There are now no limits on the amount of money people can save in a pension scheme, although there are some limits on the amount of tax relief. Savers have the opportunity to build up a tax-free pension fund of up to £1.5 million, rising to £1.8 million in 2010.

<sup>22</sup> Average annual management charges have fallen following the introduction of stakeholder pensions, from approximately 1.9 per cent in 1995 to around 1.05 per cent in the long term. Estimate is based on a male aged 25 in 2012 who is a median earner (£23,000 a year in 2006/07) saving for 43 years.

<sup>23</sup> This figure is based on the numbers of active members, deferred members and pensioners in private sector defined benefit schemes from the Government Actuary's Department's survey *Occupational Pension schemes 2005*.



29. In the past the system assumed that everyone was the same and retired at either 60 or 65. But we know that people want the freedom to choose how and when to stop work. Rather than forcing everyone into the same mould, we recognise people's different aspirations and needs.
30. Now, those who choose to claim the basic State Pension at 70 will receive £130 a week basic State Pension – over 50 per cent more than the amount at 65. The Government has taken steps to outlaw age discrimination and promote older working. Already, 1 million people above the State Pension age are in work. The employment rate of those over 50 is closing the gap with those below 50.

### Building a long-term consensus

31. Whilst these and other significant reforms to the pension system have been introduced since 1997, further reform is needed given the scale of change in society. This is why, in 2002, the Government established the independent Pensions Commission to review the regime for UK private pensions and long-term saving. It was asked to consider the longer-term pressures faced by the pension system and whether the existing voluntary pensions regime was an adequate response. The Commission concluded that there was no immediate crisis, but set out the longer-term challenge and the need for early reform.
32. If reform is to be successful it needs to be built on the foundations of a strong national consensus. That is why the National Pensions Debate was launched, culminating in a National Pensions Day involving over 1,000 people in March 2006. We invited a representative cross-section of the working age population to take part in simultaneous, interactive, discussion events in six different cities across the UK. After a day debating the issues, 88 per cent of participants agreed that people would have to save more for their retirement and almost three-quarters agreed that employees should be automatically enrolled into a personal account.<sup>24</sup>
33. *Security in retirement: towards a new pensions system* set out the Government's response to the Pensions Commission's second report. The Government committed to:
  - improving the foundation for all in retirement whilst continuing to tackle pensioner poverty. Both the basic State Pension and the standard minimum guarantee element of the Pension Credit will be uprated in line with average earnings, rather than prices. The State Pension will be made fairer and more widely available and the State Pension age will be raised in line with increasing longevity; and

<sup>24</sup> Opinion Leader Research, 2006, *National Pensions Debate Final Report*, Research carried out for DWP.

- introducing low-cost personal accounts to give those without access to employer-sponsored pension schemes the opportunity to save. People will be automatically enrolled into either their employer's scheme or a personal account, with the freedom to opt out. Employers will make minimum matching contributions.
34. Since the publication of the May 2006 White Paper, the Government has consulted widely and worked with the main opposition parties, pension experts, lobby groups and the public. This consultation was summarised in the consultation response published last month.

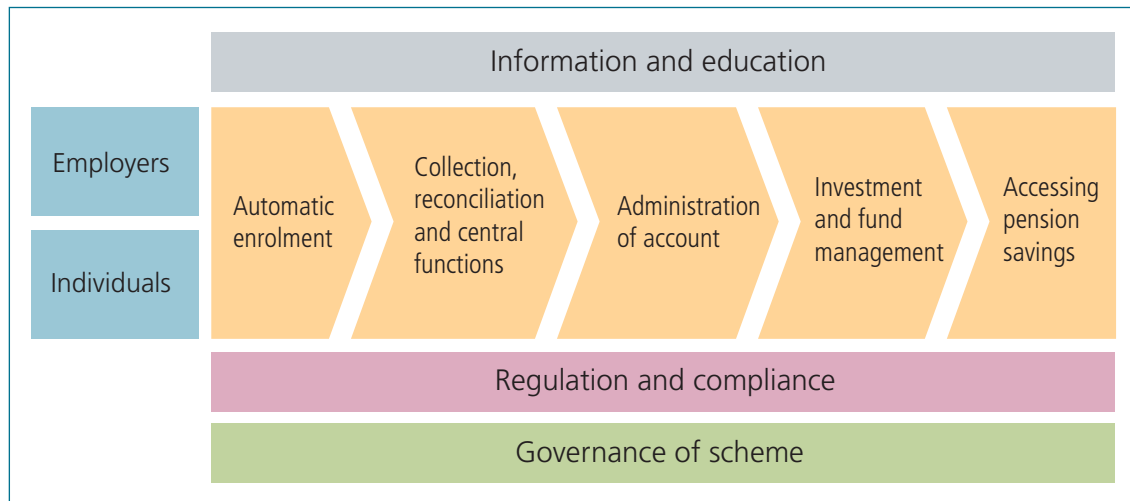
### Conclusion: empowering savers, enabling markets, ensuring fairness

35. The Pensions Commission made clear, and the Government accepted, the need to act now. Without action, tomorrow's pensioners could end up poorer than they expect to be. Our approach will reform the system to:
- **empower savers:** it is difficult for those without access to good occupational pension schemes to provide for their own retirement. Personal accounts, together with reforms to State Pensions, will enable far more people to make clearer choices about how best to plan for their retirement;
  - **enable markets:** a combination of customer inertia and high costs means that the market has not delivered for those on low and moderate incomes. Automatic enrolment into personal accounts opens up a new market for the UK pensions industry; and
  - **ensure fairness:** women have traditionally done less well from the pensions system. Reforms to State Pensions will reflect the different ways in which people contribute to society and will ensure that carers are able to build up entitlement to the State Pension. And our analysis shows that 2 to 3 million women in employment could begin saving in a personal account, or into their employer's scheme, as a result of the private pension reforms.
36. This White Paper focuses on reforming private pensions by **empowering savers** and **enabling markets**. In this summary we show how we will tackle high costs and low portability through personal accounts (Section 3), inertia and short-termism through automatic enrolment (Section 4), and incentives to save through minimum contributions matched by compulsory employer contributions and tax relief (Section 5). Together, these reforms will give everyone the chance to build up a private pension through a simple, good value, new way of saving.

### Section 3: What are personal accounts and how will they be delivered?

37. Personal accounts are intended to solve the problems of low portability and high charges. They will do this by operating as a large, multi-employer occupational pension scheme and extending the benefits of employer schemes to those currently without access to them.
38. The large scale of personal accounts means that the set-up costs can be spread over a longer period and recovered from higher funds under management, thus reducing the average charge. This large scale will allow personal accounts to achieve economies of scale similar to those of large occupational schemes. However, unlike many employer schemes, individuals will be able to keep their account as they change jobs and continue to make contributions.
39. The Government estimates that personal accounts could have between 6 and 10 million members with private pension saving of around £8 billion a year, of which approximately 60 per cent will be new saving.
40. Personal accounts are a major development in the UK pensions system and arriving at the right decision on how to deliver the scheme is vital. The May 2006 White Paper set out at a high-level those functions necessary for delivering any personal accounts system (illustrated in Figure 4):
  - **automatic enrolment:** individuals would automatically join the personal accounts scheme through their employer;
  - **collection, reconciliation and central functions:** a central clearing house would be responsible for collecting contributions through employers, handling employer queries, keeping records of contributions and ensuring that contributions are allocated to the right funds;
  - **administration of accounts:** the administrator would maintain the account for the individual, handle an individual's queries and be responsible for giving them information about their account;
  - **investment and fund management:** the fund manager would invest contributions on behalf of the saver; and
  - **accessing pensions savings:** when a saver retires they would annuitise their savings through the current annuity market, giving them a regular income throughout their retirement.

Figure 4: The structure of personal accounts



41. The May 2006 White Paper set out the broad consensus that this is the right overall structure for personal accounts. But it made clear that there were different views about how the model should be delivered. Two broad models, both based on primarily private sector delivery, had emerged:
- **the National Pension Savings Scheme (NPSS) model** – as proposed by the Pensions Commission, personal accounts would be run by a single organisation – the NPSS. Day-to-day management and operations would be outsourced to private-sector administrators. All customers would deal with the NPSS and would receive consistent service standards. Savers would be able to make decisions about whether to opt out of the scheme, whether to contribute above the minimum and their preferred approach to investment; and
  - **the provider model** – some argued that personal accounts should be delivered through existing pension providers. Rather than being governed by an arm’s length organisation, consumers would choose a pension provider. Those who did not choose would be assigned to a provider.

### Evaluating the models

42. A number of variants of these two approaches have been proposed since the publication of the May 2006 White Paper. A thorough evaluation of the possible delivery models has been undertaken by government, working closely with industry, employers and their representatives, consumer groups and regulators. The detailed evaluation is set out in Chapter 2 and the accompanying Regulatory Impact Assessment.

43. As the full evaluation makes clear, all the operational models have advantages and disadvantages. At the heart of all the models is a choice of the appropriate form of competition: competition for the market or competition for the customer. With competition for the market, providers compete to win contracts for administration or fund investment. With competition for customers, branded providers compete to win more customers.
44. Our assessment is that competition for the market will be more effective in maximising coverage and delivering low charges for the target group. Our analysis has also shown the importance that people place on simplicity in pension design. This highlights the necessity of building a scheme that simplifies the decisions people need to take and focuses their decisions on the key area of investment. For the reasons explained in the following sections, we are proposing an NPSS approach for personal accounts but with a choice of funds for those who want it.

### Maximising coverage

45. Personal accounts are intended to serve a part of the market that has not previously had access to good-value pension savings. This is a diverse group of people – many of whom will value extra choice. However, there will also be many who feel uncomfortable when expected to make complicated, unstructured choices.
46. Evidence from DWP research suggests that savers, especially those earning less than £30,000 a year, prefer not making a choice of administrator, whether from a panel or the open market.<sup>25</sup> Less financially aware consumers expressed concerns about having to make a choice, which they considered daunting, and might put them off participating. The NPSS approach offers simplicity for these individuals (and employers) and as such, is likely to maximise participation levels.

### Minimising charges

47. There is unlikely to be a significant difference in approaches to fund management between the models. Both models will use the best expertise in investment to manage individuals' funds. Low charges are critical to ensuring that people build up the maximum pension fund from their savings. A male median earner who started saving aged 25 in 2012 and saved for 43 years, could have around a 20 per cent smaller final pension fund if the level of charges was 1.5 per cent rather than 0.5 percent.<sup>26</sup>

<sup>25</sup> Hall S, Pettigrew N and Harvey P, 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>26</sup> In this analysis we assume that there is no relationship between annual management charges and the returns achieved by managers for investors. 'Active' fund managers usually charge much higher fees compared with 'passive' fund managers, but evidence to date suggests that both types of fund managers achieve a similar rate of return. Research on this area is ongoing.

48. Higher levels of persistency are expected in the NPSS approach as it will not be based on firms competing to encourage people to switch. This, along with reduced marketing costs due to firms not competing for individual accounts, should drive down costs. As a result, the NPSS approach is expected to be 20 to 25 per cent cheaper than a system based on direct competition between firms for individuals. Like the Pensions Commission, we are confident that the scheme can achieve a radical reduction in pension charges even in the short term and we will give the personal accounts board a statutory duty to deliver low costs to its members. We estimate that the long-term costs for personal accounts will be in line with those set out by the Pensions Commission of around 0.3 per cent of funds under management or even lower.
49. Some of those proposing models with competition between branded providers have suggested that in the longer term these models would be cheaper as competition would drive down costs over time. There is little evidence that competition for customers will provide significant downwards pressure on charges. Recent falls in charges have been a result of regulation, not competition. Similarly, international evidence from other countries shows that the lowest-cost systems are those with a limited choice of provider and/or investments – for example the Thrift Savings Plan in the United States.

### Minimising delivery risk

50. Simplicity is key to building a successful scheme. It is what individuals say they want and it will help to minimise delivery risks. The NPSS approach to personal accounts offers a clear line of accountability and responsibility for the overall project. It minimises the number of points of contact for employees and employers, and minimises the number of links between providers – where problems can typically occur. In contrast, the provider-led model would involve multiple contracting partners with no one body in overall control.
51. The simplicity of the scheme can affect the level of consumer protection. The Financial Services Authority has pointed out<sup>27</sup> that the risk of aggressive competitive practices, which could be detrimental to consumers, is removed in the NPSS approach. Confidence among individuals that any system of personal accounts is run in a fair and transparent manner is necessary to encourage people to remain opted in to the scheme. International experience, for example the Swedish PPM system, shows that pension schemes on this scale can be implemented successfully.

<sup>27</sup> *Security in retirement: towards a new pensions system*, The Government's White Paper on pension reform – Financial Services Authority response.

### Investment choice in personal accounts

52. Evidence<sup>28</sup> reveals a widespread lack of confidence among UK consumers in their ability to make decisions about financial products. In our target market, this is aggravated by low levels of financial capability.<sup>29</sup>
53. Personal accounts, therefore, must be designed so that they work for this part of our target group. We need to structure the choice so that as many as possible feel confident making the right decisions for themselves and those that do not feel able to take decisions are not disadvantaged.
54. Those who want a simple approach to saving will only have to decide whether to remain in the scheme and how much to contribute:
- There will be a default fund for this group.
  - It will be for the personal accounts delivery authority (see Section 7) to design an appropriate default fund that balances the need to maximise returns against the risk of individuals' funds falling in value.
  - We anticipate that the default fund will need to invest in a wide range of assets to reduce the risks associated with the performance of specific assets.
  - The default fund is also likely to incorporate a degree of lifestyling<sup>30</sup> to reduce the risks around the time of accessing savings.
55. Whilst the majority will be content with this level of choice, research shows that some members of our target group will want additional options.<sup>31</sup> This could be a choice of administrator, fund or both. Whilst some on higher incomes said they would like a choice of administrator, the price of delivering choice for this small group would be higher charges for all customers. Given that high income customers are already well served by private pensions, choice of administrator is not a priority for personal accounts.

<sup>28</sup> Marketing Sciences (2006), *Retirement Planning Monitor*. Hall, Pettigrew and Harvey, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>29</sup> Atkinson A, McKay S, Kempson E and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey* Financial Services Authority Consumer Research Report, 47.

<sup>30</sup> where members' contributions are invested in riskier, higher return assets when they are young, and then in safer assets, such as gilts, as they get close to retirement.

<sup>31</sup> Hall, Pettigrew and Harvey, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.



56. Research suggests that there is a demand for additional fund choice.<sup>32</sup> In particular, younger respondents say they want to have the choice to invest ethically<sup>33</sup> and it may also be the case that there will be demand for investment options that conform to religious beliefs.
57. We will, therefore, task the delivery authority and then the personal accounts board to design investment options that best meet the needs of members. This will include a default fund and we expect it to include other options such as social, environmental and ethical investments, and branded funds. The inclusion of extra fund choice for those that want it could provide competitive pressure on the main investment funds as well as promoting personal responsibility amongst this group by encouraging higher contributions. It will be important to structure the choice of investment so that it benefits those who want to make a choice, without making the scheme confusing, whilst ensuring that charges are fair between different groups of customers.
58. The delivery authority and the personal accounts board will design these options based on consultation with people in the target group. The role of the Government will be to set down the general objectives for personal accounts but not to be involved in specific investment decisions.
59. Clearly, the investment options will need to be able to evolve over time, and the personal accounts board will need to take account of the changing trends in financial markets to refine what is available and how choice is delivered.

## Governance

60. Personal accounts will be a defined contribution, occupational scheme. The personal accounts board will be responsible for oversight and prudent management of the scheme as a whole. It will ensure that the scheme operates smoothly within the framework set out by legislation, and according to the principles of good governance and accounting. It will ensure that funds are invested prudently and in the best interests of members. In particular, it will be responsible for ensuring that contractors carry out their functions efficiently and in accordance with obligations set by the statutory framework.
61. It is the Government's expectation that the personal accounts regulatory regime will be based on the existing framework rather than adding to the regulatory landscape. Work to decide the allocation of regulatory roles will be taken forward alongside the deregulatory and institutional reviews, and in consultation with the appropriate bodies.

<sup>32</sup> Malcolm K and Wilsdon T, 2006, *Branded choice in personal accounts*, CRA International.

<sup>33</sup> Hall, Pettigrew and Harvey, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.



## Section 4: What this will mean for individuals?

62. Personal accounts are designed for the approximately 10 million people who are currently not participating in a pension scheme offering at least a 3 per cent employer contribution, are aged between 22 and State Pension age and earning over £5,000. This is the target group for personal accounts. We know that employees who are not currently contributing to a private pension tend to be younger and on low to moderate incomes. They are also likely to be part-time workers and/or to work for small employers. A high proportion of women are lower earners and are less likely to be members of an employer pension. Personal accounts will help to address this.
63. We propose that:
- individuals will be automatically enrolled if they earn above £5,000;
  - employees will pay contributions of around 4 per cent on their earnings between approximately £5,000 and £33,500 a year<sup>34</sup>;
  - the employee contribution will be matched by 3 per cent from the employer together with around 1 per cent in the form of normal tax relief from the State<sup>35</sup>;
  - the band of earnings on which contributions will be paid will be uprated in line with earnings to ensure the scheme is sustainable;
  - employees aged over 22 and below State Pension age will be eligible for automatic enrolment; and
  - employees outside these age bands will be able to opt in to the scheme, with access to an employer contribution if they fall within the earnings bands.
64. The Pensions Commission argued that a voluntary approach would never be enough to change pension savings behaviour. They recommended that we create a new form of saving, where employees are automatically enrolled into a pension, and have to make an active decision not to save, to tackle the problems of the short-termism and inertia of savers.

<sup>34</sup> When launched, the limits for the personal accounts earning band will be aligned with the Primary Threshold and Upper Earnings Limit for National Insurance contributions (£5,035 and £33,540 a year respectively in 2006/07).

<sup>35</sup> 1 per cent represents basic rate tax relief on individuals' contributions – in addition, individuals may be entitled to higher-rate tax relief and neither employers nor employees pay tax or National Insurance contributions on employer contributions.

65. This does not mean employees will be compelled to save. The Commission rejected a compulsory approach to private saving because there will always be some groups who should not be saving towards a pension – for example those paying off high burdens of debt. But the Commission argued that automatic enrolment was necessary to help people make the right choice for their retirement and the Government agrees.
66. Evidence shows that automatic enrolment is one of the most effective ways of combating people's tendency not to act when faced with difficult financial decisions.<sup>36</sup> Automatic enrolment has the greatest impact among groups where participation rates are low. American research into 401(k) schemes showed that automatic enrolment had the largest effect among people with low incomes, minority ethnic groups and women.<sup>37</sup>

#### Responses to automatic enrolment

"The CBI supports automatic opt-in policies and has consistently encouraged firms to consider introducing such a practice."

(Confederation of British Industry)

"We believe the 'soft compulsion' of auto-enrolment represents the right balance between encouraging and forcing saving."

(Age Concern)

#### How will automatic enrolment work in practice?

67. When an employee starts work, they will be automatically enrolled into a pension; either into a personal account or into their employer's pension scheme. We have decided that employees aged under 22 should not be automatically enrolled in this way, because the evidence suggests they are more likely to move jobs more frequently.<sup>38</sup> The administrative costs associated with frequent job changes in this age group might reduce the incentives for employers to hire younger workers. In addition, it is likely that younger workers' employment is more sensitive to non-wage costs, which is why the minimum wage has a lower rate below 22.

<sup>36</sup> *The Employers' Pension Provision Survey 2005* findings show a link between automatic enrolment and increased levels of pension scheme membership. Within private firms with 20 or more employees, the proportion of employees that were in a pension averaged 60 per cent (median 77 per cent) where the firm used automatic enrolment. This compared with 41 per cent for traditional opt-in.

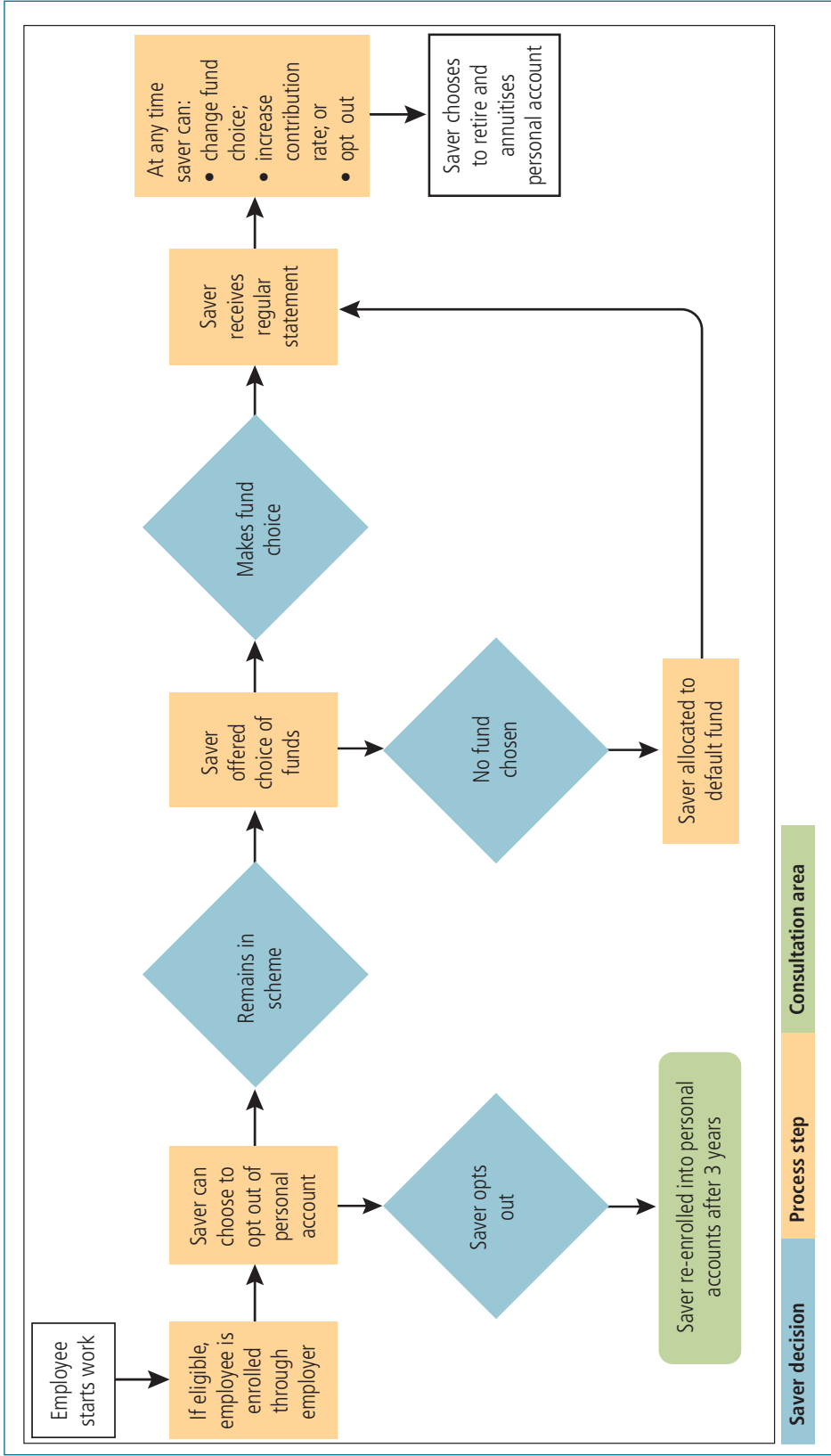
<sup>37</sup> Madrian and Shea, 2002, in Munnell and Sunden, 2004, *Coming up short: The challenge of 401(k) plans*, The Brookings Institute.

<sup>38</sup> Under 22-year-olds are more likely to move between various labour market states and change employment than people over 22. This is based on average annual flow data, Labour Force Survey, spring/summer 1997 to winter/spring 2004.

68. Employees will contribute around 4 per cent of their salary on their income between the earnings limits of around £5,000 and £33,500. This will be matched by a contribution of 3 per cent from their employer and around 1 per cent from the normal tax relief available on individual pension contributions.
69. The Pensions Commission recommended an 8 per cent combined contribution with the goal of providing a minimum level of pension for most people. Based on their research with individuals<sup>39</sup>, they argued that the minimum the median earner wanted in retirement was 45 per cent of their working income. These contribution levels are intended to achieve that level, although actual outcomes will obviously depend on a number of factors, for example investment returns.
70. Many people will want more than this level of pension and should, therefore, benefit from additional contributions. These extra contributions would attract normal tax relief but not a matching employer contribution. The personal accounts board will be given a duty to encourage saving above the minimum level of contributions.
71. Once personal accounts are up and running and a new employee already has a personal account from a previous job, the employee could be 'fast-tracked' back into personal accounts. Figure 5 illustrates the individual experience of being automatically enrolled into a personal account.

<sup>39</sup> Pensions Commission, 2005, *A new pension settlement for the twenty-first century: The second report of the Pensions Commission*, TSO.

Figure 5: The individual's experience in personal accounts



72. Government provides generous tax relief to those who save in tax-advantaged pension schemes to encourage individuals to save for an income in retirement. Personal accounts will be a tax-registered pension scheme and so individual savers will have access to pensions tax relief on contributions. This means that for a basic rate taxpayer every £1 saved will be matched by 28p from the State.
73. Automatic enrolment will help people save for a pension. But it does not replace people's responsibility to ensure that their retirement income meets their expectations. The goal of our policy is to give people a reasonable expectation that if they save in a pension they will be better off for having done so. Whether to save or not must remain the individual's decision.

### Impact of the state pension reforms

74. The state pension reforms currently before Parliament will provide a firm foundation on which people can build through their private saving to reach the standard of living they would like in retirement:
- **Increased coverage of State Pensions** – in the past, women and carers have not had the same access to State Pensions as men. After reform, around 75 per cent of women reaching State Pension age in 2010 will be entitled to a full basic State Pension and this will reach over 90 per cent of women (and men) by 2025.
  - **Reduced reliance on Pension Credit** – restoring the link between earnings and the basic element of the State Pension, and changes to how Savings Credit is calculated, will ensure that Pension Credit remains targeted at the groups who need it. We estimate that without change and assuming continued uprating policy, by 2050 around 80 per cent of pensioner households would have been entitled to Pension Credit. With the reform package, that will fall to around 30 per cent in 2050. This will mean that there will be greater benefits of saving for more people.
75. The state reforms will ensure that Pension Credit is targeted at those who need it – namely, groups who have not been able to contribute for enough years to build up rights to a sufficient State Pension.
76. As a result of the reforms, anyone who contributes for 24 years or more will be lifted above Guarantee Credit only. The Government will be able to give workers a reasonable expectation that if they work and/or care, and save, for most of their career they will not be on Pension Credit on retirement. Without reform, that would not have been possible.
77. Pension Credit will continue to be an important safety net for those who are not able to make such provision – but there will still be good incentives to save.

78. Lower charges and the presence of an employer contribution will directly enhance the value of pension funds. Payback will clearly depend on a range of factors such as investment performance<sup>40</sup>. However, in the reformed system, in real terms, a median earner aged 25 in 2012 might expect payback of £2.55 for each £1 saved, compared with £1.13 for every £1 saved without reform, as illustrated in Figures 6a and 6b<sup>41</sup>. Someone receiving Savings Credit in 2050 could still get a return of £2 for every £1 saved.
79. The result of the reforms, bearing in mind the difficulty of all long-term predictions, is that there will only be a small group of people – less than 10 per cent of pensioner households in 2050 – who may not see any benefit from saving. To fall within this group, people would have to have a severely deficient state pension record and not have earned above £5,000 in many years of their working life. They are thus unlikely to have been automatically enrolled into a personal account or alternative pension scheme for long, and will have accumulated relatively small pension funds. Even this group may benefit as they will be able to take their pension as a lump sum if the total is less than the trivial commutation limit (£15,000 in 2005/06).
80. The reforms to State Pensions combined with the employer contributions mean that the incentives to save are better for all age groups compared to the system prior to reform. Very few people will see little or no benefit from saving. The majority will see significant returns.
81. Some people will rightly decide not to save for a pension. They could include those on persistent very low incomes or those struggling with high unsecured debt. But the large majority of people can expect to benefit from saving. Ultimately, it should be for the individual to decide whether and how much to save based on their particular circumstances.

<sup>40</sup> *Financial incentives to save for retirement*, November 2006, [www.dwp.gov.uk/pensionsreform/pdfs/financialincentives.pdf](http://www.dwp.gov.uk/pensionsreform/pdfs/financialincentives.pdf)

<sup>41</sup> These savings are reinforced by Sefton J, van de Ven J and Weale M, December 2005, *The Effects of Means-Testing Pensions on Savings and Retirement*.

**Figure 6a: Potential payback from £1 contribution for a male median earner aged 25 in 2012, without proposed reforms**

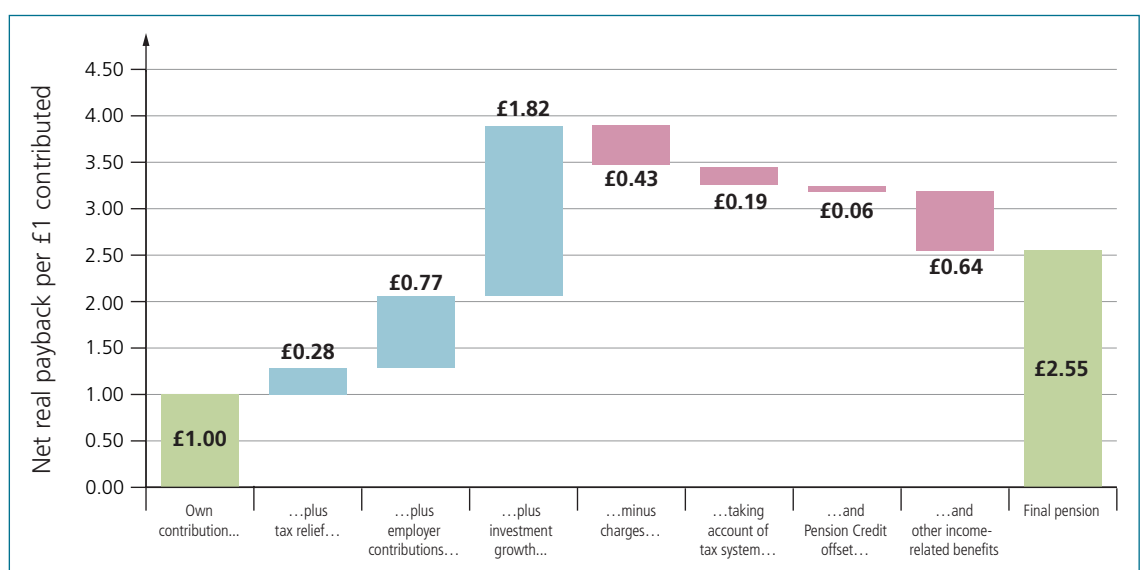


Source: DWP modelling

Notes: Median earnings in 2006/07 are £23,000.

This figure is for illustrative purposes only. It should not be used as the basis for individual decisions as specific circumstances or variation from the underlying assumptions will lead to different results.

**Figure 6b: Potential payback from £1 contribution for a male median earner aged 25 in 2012, with proposed reforms**



Source: DWP modelling

Notes: Median earnings in 2006/07 are £23,000.

This figure is for illustrative purposes only. It should not be used as the basis for individual decisions as specific circumstances or variation from the underlying assumptions will lead to different results.

## Section 5: What this will mean for employers?

82. The Pensions Commission argued that all parts of society share the responsibility for tackling the problem of undersaving for retirement. Individuals would need to save more, the State would need to spend more – but employers would also have to increase their contributions.
83. Historically, employers have played a significant role in providing pensions. The existence of workplace pension schemes created a suitable product, and the efforts which employers (and trade unions) made to encourage people to join helped overcome inertia.
84. Many employers are committed to continuing to play that role, and the Government will continue to support them. However, the Pensions Commission made clear that pensions policy could not be based on the expectation that all employers would fulfil this role in the future.

### The minimum employer contribution

85. In the May 2006 White Paper the Government announced the introduction of a minimum employer contribution of 3 per cent on a band of earnings. This contribution is the central pillar of this package of reforms. Without it, employees would not have a sufficient incentive to save. The contributions from the employer, together with tax relief, give workers a good expectation that saving will be worthwhile. Without this confidence, automatic enrolment on a large scale would not be possible. And without both these factors, we would not be able to increase participation in private pensions.
86. The role of employers is, therefore, crucial in making this policy work. However, the Government recognises that business will need time to adjust to this and employers will, therefore, be given enough time to adapt through the early provision of information about their new responsibilities and through the phased introduction of contributions. The employer contribution level will be set in primary legislation, to give employers clarity and certainty about the rate.
87. Our research shows that employers are supportive of the reform package and accept that they have a role to play. Around two-thirds of employers thought that a minimum employer contribution level of 3 per cent was either about right or not enough, and six in ten organisations with less than 50 employees thought automatic enrolment was a good idea, rising to eight in ten employers with 250 or more employees.<sup>42</sup> Nonetheless, employers will face increases in costs: our research suggests that these will be around 0.7 per cent of labour costs on average.

<sup>42</sup> Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*, DWP Research Report No 397.



88. The priority is to design the scheme and the transition phase so that burdens on employers are minimised. The Government is determined to ensure the system is operated in a way that imposes minimum administrative burdens on business.

### How will the employer contribution work in practice?

89. These reforms must meet a basic test: they have to be simple to run for a small employer, such as the corner shop or plumber who will be covered by this scheme. The first decision for the employer will be whether they want to continue, or start, to provide a pension themselves. If they decide not to do that, they will be required to pass on 4 per cent from their employee's salary to the clearing house and match that with a 3 per cent employer contribution. The need to keep this a light-touch process is one of the two key reasons why a clearing house is necessary to implement personal accounts: as well as ensuring portability of pensions for employees, it will mean that employers need have only one point of contact for transferring these contributions.
90. We will task the delivery authority and then the personal accounts board with the objective of minimising the administrative burden on employers. This will be a key factor in the design of, and contracting for, the clearing house. The delivery authority will consult closely with employers on how to do this, including on whether the clearing house could build on existing collection mechanisms.
91. Some consultation responses, and some of the models which we considered, recommended that the employer should give advice to their employees about which provider to choose, or which funds to invest in. However, consultation with employers has clearly shown that a majority of employers do not wish to do this. Personal accounts will be designed so that employers are not required to give such advice.

### Scheme exemption

92. The Government wants to support employers who choose to offer their own pension schemes. That is why we are proposing to exempt employers from the requirement to automatically enrol their employees into personal accounts if they operate a scheme of broadly equal, or better, value to personal accounts and automatically enrol employees into it.
93. We want to make the exemption process as light-touch as possible. Our consultation with employers over the summer identified ways of achieving this for occupational schemes. The test for most defined benefit schemes will be based on the existing scheme reference test, which employers already use to decide whether to contract out of the State Second Pension. The test for defined contribution schemes will be based on the employer providing contributions at the same level as personal accounts. In both cases employers will be able to check, in consultation with their scheme or provider, that the scheme qualifies for exemption and then certify that it is exempt.

94. Many consultation responses expressed concern that personal accounts would result in some employers already offering a scheme levelling down to the 3 per cent contribution level. The Government takes these concerns seriously and this White Paper suggests some ways to minimise the direct effect of personal accounts on existing provision. In particular, we are consulting on whether companies that offer higher-value schemes should be allowed to have a reasonable waiting period. This would allow them to continue to use their pension scheme as an incentive to employee loyalty, and could encourage employers to level up to that higher contribution level. The Government is also interested in working with the industry on the National Association of Pension Fund's (NAPF's) suggestion of a 'good' pension scheme kitemark to help employees identify companies that offer such pensions.

### Waiting periods

95. The May 2006 White Paper consulted on whether there should be a waiting period before automatic enrolment. A number of responses to the White Paper argued for a waiting period of six months or even a year. We will continue to consult on this issue, but there is strong evidence against having a waiting period:
- Employer groups were split on the issue of a waiting period, with a number arguing it would be a greater administrative burden for employers to have to remember to enrol employees at a later stage, rather than on joining.
  - Most existing occupational schemes do not have waiting periods, with only 16 per cent operating one.<sup>43</sup>
  - A waiting period of six months could reduce pension funds by 10 per cent: a waiting period of a year by 20 per cent.
  - A waiting period would disproportionately affect temporary workers, and therefore undermine our goal of making pensions portable between jobs.
96. Given that it could undermine a key goal of our reforms, we are not proposing a formal waiting period in personal accounts.

<sup>43</sup> Source: Supplementary analysis of data from the Government Actuary's Department, *Occupational Pension Schemes 2005*.

## Compliance

97. The new rights for employees to be automatically enrolled into either a personal account or into an exempt work-based pension arrangement, will be protected by a light-touch compliance regime based on:
- educating employees about the value of their new rights and employers about their new obligations;
  - enabling employers to comply through processes and helplines designed to support them; and
  - enforcing compliance by the minority of employers who deliberately fail to meet their legal obligations.
98. We will be consulting further on the detail of the compliance regime. We expect to build upon the model used for enforcing the National Minimum Wage, which combines the right of employees to take their case to an employment tribunal with whistle-blowing and risk-based investigation. To ensure minimal impact on the majority of employers who will do their best to comply with the new requirements, personal accounts will be designed to allow cases of possible non-compliance to be identified by remote data matching in the first instance.
99. Employers are keenly aware of the long-term challenges that are facing the pensions system. If no action were taken today, employers would risk facing increased taxation in the future to prevent coming generations of pensioners falling into poverty. Personal accounts are intended to prevent that problem. It is in the shared interest of employees and employers to act now. Moreover, the overall impact of our reforms is predicted to increase Gross Domestic Product (GDP), because of the increase in savings and the growth in employment from raising the State Pension age. We will continue to work closely with employer groups to ensure this new responsibility is implemented effectively and efficiently.

“The EEF welcomes the assistance that the Government states in the White Paper it will be providing for employers, particularly having the minimum employer contribution into the new pensions saving scheme set out in primary legislation and the phasing in of both employer and employee contributions over three years.”

(Engineering Employers’ Federation)

## Section 6: What will this mean for the financial services industry?

100. Personal accounts should complement, rather than compete with, existing good-quality pension provision. There will be no public policy benefit if personal accounts result only in existing pension saving being moved from one savings vehicle to another.
101. Personal accounts are designed to serve up to 10 million people who do not have access to, or are not participating in, a pension scheme offering at least 3 per cent employer contributions. These reforms will effectively open up a new segment of the market to the financial services industry and will be a significant new business opportunity:
  - Firms with relevant administrative expertise will have the opportunity to manage the personal accounts scheme for potentially 6 to 10 million customers.
  - It is estimated that personal accounts will increase the level of private pension savings by an estimated £8 billion a year, of which approximately £4 to £5 billion will be new saving. Fund managers will compete to invest the £150 billion which is expected to accumulate in personal accounts in the long term.
102. In addition, we have taken steps to limit the impact on the successful parts of the market to ensure personal accounts complement, rather than replace, existing pension provision.

### No transfers in or out of personal accounts

103. The Government proposes that there should be no transfers into or out of personal accounts from or to existing pension schemes. There are clear advantages in this approach:
  - Adverse impact on the existing market would be minimised. The start-up costs incurred when establishing pension products may not be recovered if funds are transferred into personal accounts.
  - Administrative cost and complexity associated with transfers, such as valuing pension rights, would be avoided.
  - There would be no need for advice from financial advisers to compare the relative advantages of the existing scheme and personal accounts, the cost of which individuals themselves would have to bear.
  - It would send an important psychological signal to employers and individuals that personal accounts are targeted at a specific market and this could be an important safeguard against the 'levelling down' of existing provision.

### Annual limit on contributions

104. The Pensions Commission recommended that there should be an annual limit on the total value of contributions into a personal account. They suggested around £3,000 a year, which was twice the total minimum contribution for a median earner.
105. Further analysis indicates that the £3,000 contribution limit would be too restrictive to allow a range of individuals within the target group sufficient room to make additional contributions and reach higher replacement rates, which may reflect individual retirement aspirations. This analysis suggests that an appropriate limit, at least in the first years of personal accounts, would be £5,000. Chapter 7 provides more details of this analysis.
106. We propose to review both the limit and transfer policy in 2020, when the market impacts of the 2012 reforms are better understood, to ensure these policies are operating effectively.
107. The Government believes that there is a strong case for a higher contribution limit in the first year of personal accounts. A £10,000 limit in the first year of personal accounts would allow individuals to deposit accumulated non-pension savings in personal accounts. This additional allowance for the first year of personal accounts will allow individuals who currently do not have access to good-quality employer-sponsored pension provision to save in other products before 2012 and move them to personal accounts.

### Section 7: A delivery authority to support reform

They would have to guarantee that even if Governments change, it will still be there and it won't be null and void after four years."  
(35-49, £15-30k)<sup>44</sup>

108. People need confidence that their money is being managed responsibly and that members' interests are at the heart of the organisation. Managing a major new occupational pension scheme is not a job for government. For this reason we have proposed setting up a delivery authority in the Pensions Bill currently before Parliament.
109. The wealth of expertise in business and financial services is in the private sector. Stakeholders across industry, employers and consumer representatives all agree that harnessing the skills of the private sector to deliver personal accounts within a framework set by government is the best way to build credibility and public confidence. We therefore propose to bring in leading experts from the private sector to help develop, deliver and manage the personal accounts scheme.

<sup>44</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

110. Initially, the delivery authority will act in an advisory capacity on the detailed design of personal accounts and on the commercial and procurement strategies.
111. We will build on this structure, expanding the remit of the delivery authority and providing it with the necessary independence and powers to establish personal accounts. In addition the delivery authority will need to look at both the charging structure and investment strategies that are to be put in place; neither are areas where government has expertise. It will be vital to ensure that investment strategies are independent from politicians and pressure groups and that they are developed with members' interests at their heart. The delivery authority will be replaced by the personal accounts board which will then be responsible for the live running of the scheme.
112. It will be the Government's role to lay down the remit for the delivery authority and personal accounts board to ensure that personal accounts can and do deliver the objectives of the reform. The remit is expected to include:
  - achieving optimal participation rates among the target group;
  - achieving low charges and costs;
  - encouraging additional contributions above the minimum 8 per cent level;
  - ensuring high levels of customer service;
  - a duty to act transparently and adopt a consultative culture;
  - setting an investment strategy in the best interest of members;
  - providing appropriate degrees of consumer protection; and
  - minimising impact on other good pension provision and employers more generally.
113. Members' needs must remain at the heart of personal accounts. As a minimum, the personal accounts board will be required to be open and consultative in its approach to making decisions. For example, we would expect the board to consult on its approach to ethical funds and to shape the funds that are available in accordance with members' wishes. Consultation could include the innovative deliberative polling approach which worked well in the National Pensions Debate. But the Government also wants to explore how members can influence the board's operations, as well as being consulted. Options on this could range from advisory bodies to representation on the board, and we would welcome views on the best approach to put members at the heart of personal accounts.

## Conclusion: outcomes and next steps

114. Personal accounts are at the centre of our pension reform package. Combined with the proposed changes to the state pension system, we are in a position to make a lasting, sustainable set of reforms, supported by a strong evidence base and wide consensus across society.
115. Personal accounts will be delivered by a modern type of organisation: managed independently and for its members, though within a framework set by the Government; not delivered by the State, but by the private sector. Our goal is to set the framework for people to take responsibility for themselves: enabling millions of people to save for their retirement; making difficult choices easier and ensuring that there is a range of choice to suit everybody, whatever their level of income or financial understanding.
116. The reform package will lead to a significant shift in the pension savings culture in the UK. Our research indicates that we can expect:
- potentially between 6 and 10 million members of personal accounts;
  - £8 billion a year in contributions, of which £4–£5 billion will be new saving;
  - a radical reduction in charges faced by pension savers leading to final pension funds that could be 25 per cent larger;
  - improved incentives to save; and
  - an invigorated and expanded pensions market.
117. The Pensions Commission warned that, without action, future generations of pensioners would be poorer than today's. We are taking that action now by introducing these reforms. Automatic enrolment will help overcome inertia and short-termism. Personal accounts will lower charges and improve portability. Together with the minimum employer contribution, they will transform incentives to save for ordinary working families.
118. The Government has now set out its plans for reform of both private and State Pensions. The State Pension will become fairer and more generous, providing a solid platform on which people can save. Personal accounts will extend the benefits of work-based saving to those who have not so far had that opportunity. Together, these reforms amount to one of the most significant reforms of the welfare state since Beveridge. They are based on the State as an enabler, giving people control over their lives. To work, these reforms need the commitment not just of the Government but of all parts of society. To last, they need to command a consensus both now and during implementation. We will continue to work to deepen that consensus with all those with a stake in a success of these reforms.







## Chapter 1:

### Individuals and automatic enrolment



# Chapter 1: Individuals and automatic enrolment

Automatic enrolment is one of the most effective ways of combating people's tendency not to act when faced with difficult financial decisions. It is central to tackling the problem of undersaving.

Recent analysis suggests that approximately 7 million people are not saving enough to give them retirement incomes they are likely to consider adequate.<sup>1</sup> Personal accounts will extend the benefits of private pension saving to those on moderate to low incomes who do not have access to a good employer pension scheme. The target group will include many younger employees and people who work for small firms.

In future, individuals will be automatically enrolled into exempt work-based pension schemes or personal accounts if they are employees aged between 22 and State Pension age, and earning above approximately £5,000 a year.

Contributions will be made on a band of earnings between around £5,000 and £33,500 a year, the personal accounts earnings band<sup>2</sup> (PAEB), which will be increased in line with earnings.

These reforms will provide good incentives to save. The combination of the employer contribution, tax relief and lower costs, combined with a reformed state pension system, will mean that saving will be worthwhile for the large majority of the personal accounts target group.

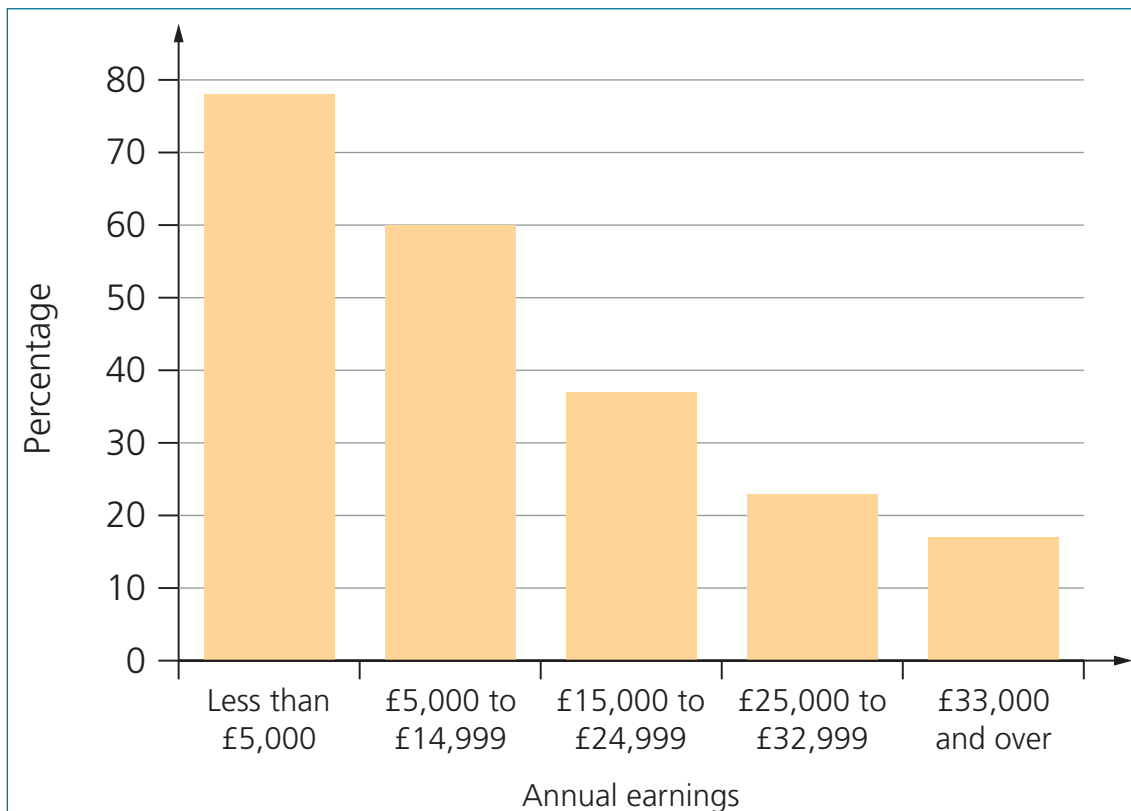
<sup>1</sup> Estimates of the current level of undersaving for retirement are difficult to construct due to: difficulties identifying appropriate saving targets; uncertainties about which kinds of wealth and asset to take into account; difficulties projecting individuals' future saving and working patterns, particularly around choice of retirement age; reliance on inadequate data; and reliance on a range of other uncertain assumptions, including the impact of future macro-economic developments. Consequently, such estimates should be treated cautiously. The current Department for Work and Pensions (DWP) estimate draws on analysis by the Institute for Fiscal Studies (Banks J, Emmerson C, Oldfield Z and Tetlow G, 2005, *Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England*, IFS). The May 2006 White Paper (*Security in retirement: towards a new pensions system*) sets out some of these issues in more detail.

<sup>2</sup> Employee and employer contributions will be calculated on earnings that fall within the PAEB. When launched, the limits for the PAEB will be aligned with the Primary Threshold and Upper Earnings Limit for National Insurance contributions at the time (£5,035 and £33,540 a year, respectively, in 2006/07).

## The target group

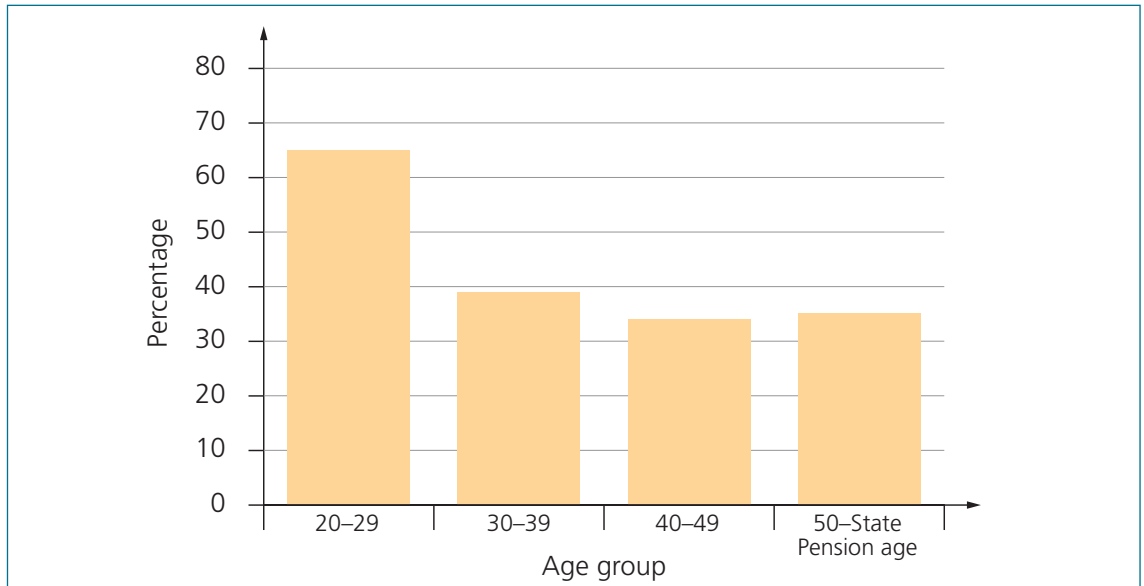
- 1.1 Personal accounts are particularly targeted at the estimated 7 million people who may not be currently saving enough to give them an income in retirement they are likely to consider adequate. We know that this group tends to be younger and on moderate to low incomes. They are also likely to be part-time workers and/or work for small employers. A high proportion of lower earners are women who are not likely to be saving in work-based pension schemes.
- 1.2 We have analysed the various groups where participation in private pension saving is lowest. These include:
- employees on moderate to low incomes, particularly those with incomes below about £15,000 a year (see Figure 1.1);
  - younger people, especially those in their 20s and 30s (see Figure 1.2); and
  - women, who are a significant majority of those with lower earnings in this target group (see Figure 1.3).

**Figure 1.1: Percentage of employees not contributing to a private pension by earnings band**



Source: Family Resources Survey 2004/05, UK

Figure 1.2: Percentage of employees not contributing to a private pension by age group



Source: Family Resources Survey 2004/05, UK

Figure 1.3: Breakdown of the target group, excluding higher earners, by gender and earnings



Source: Family Resources Survey 2004/05, UK

Notes: Private pension participation has been used as a proxy for participation in a pension with a 3 per cent or more employer contribution. Higher earners are defined as those earning £33,000 or over a year.<sup>3</sup>

<sup>3</sup> For this analysis the target group is defined as employees aged 22 to State Pension age (currently 65 for men and 60 for women), earning between £5,000 and £33,000 a year, and not in a private pension scheme.

- 1.3 The barriers which stop the target group from saving enough for retirement are:
- the complexity of the current pension system meaning the incentives to save are not clear;
  - the relatively high charges associated with pension products; and
  - a behavioural tendency not to act when faced with difficult financial decisions.
- 1.4 The Government is introducing legislation to tackle the first of these. A Pensions Bill with provisions to change the state pension system is currently before Parliament. Personal accounts, with automatic enrolment and a minimum employer contribution, are designed to tackle the second and third barriers to saving.

## Automatic enrolment

---

- 1.5 The reforms to private pensions have been designed with people on moderate to low incomes in mind. In the May 2006 White Paper *Security in retirement: towards a new pensions system* the Government set out its proposals:
- employees will be eligible for automatic enrolment if their earnings exceed the lower limit of the PAEB of around £5,000<sup>4</sup> a year;
  - employee contributions will be around 4 per cent of their earnings between approximately £5,000 and £33,500 a year;
  - employees' contributions will be phased in over three years;
  - the employee contribution will be matched by 3 per cent from the employer, together with around 1 per cent from the State in the form of normal tax relief;
  - the PAEB, on which contributions will be calculated, will be uprated in line with earnings to ensure contributions keep pace with incomes;
  - employees aged over 22 and below State Pension age will be eligible for automatic enrolment; and
  - employees outside these age bands will be able to opt in to the scheme.

<sup>4</sup> When launched, the limits for the PAEB will be aligned with the Primary Threshold and Upper Earnings Limit for National Insurance contributions (£5,035 and £33,540 a year respectively in 2006/07).

- 1.6 Evidence shows that automatic enrolment is one of the most effective ways of combating people’s tendency not to act when faced with difficult financial decisions<sup>5</sup>. Automatic enrolment has the greatest impact among groups where participation rates are low. American research into 401(k) schemes showed that automatic enrolment had the largest effect among people with low incomes, minority ethnic groups and women.<sup>6</sup>
- 1.7 This does not mean employees will be compelled to save. The Commission rejected a compulsory approach to private saving because there will always be some individuals who should not or may not want to be saving towards a pension, for example, those paying off high levels of debt. However, the Commission argued that automatic enrolment was necessary to help people make the right choice for their retirement. In the May White Paper this approach to increasing the number of savers was endorsed by the Government.

“EEF supports the Government’s proposals that employees should be automatically enrolled into a new pensions saving scheme with their employer also having to make contributions to the scheme if they decide to be auto enrolled.”

(Engineering Employers’ Federation White Paper response, September 2006)

“We believe the ‘soft compulsion’ of auto-enrolment represents the right balance between encouraging and forcing saving.”

(Age Concern)

## How automatic enrolment will work in practice

---

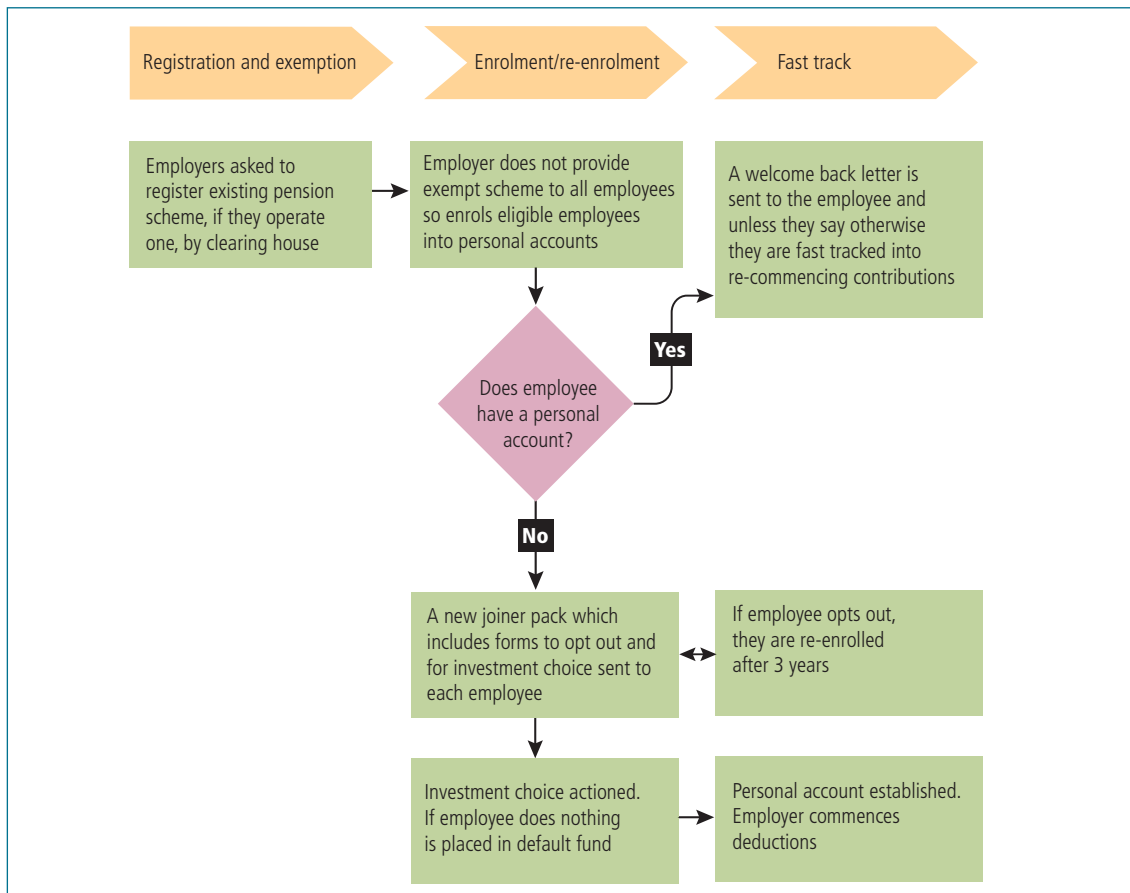
- 1.8 When an employee starts work they will be automatically enrolled into a pension – either into the employer’s exempt pension scheme or into personal accounts. Employees over State Pension age may opt in to personal accounts and receive an employer contribution on qualifying earnings. Employees under 22 will not be automatically enrolled but may opt in to personal accounts.

<sup>5</sup> The *Employers’ Pension Provision Survey 2005* findings show a link between automatic enrolment and increased levels of pension scheme membership. Within private firms with 20 or more employees, the proportion of employees that were in a pension averaged 60 per cent (median 77 per cent) where the firm used automatic enrolment. This compared with 41 per cent for traditional opt-in.

<sup>6</sup> Madrian and Shea, 2002, in Munnell and Sunden, 2004, *Coming up short: The challenge of 401(k) plans*, The Brookings Institute.

- 1.9 The Pensions Commission recommended an 8 per cent combined contribution with the goal of achieving an adequate minimum level of pension for most people. Based on their research<sup>7</sup>, they argued that the minimum the median earner wanted in retirement was 45 per cent of their working income. The 8 per cent contribution is intended to achieve that level, although actual outcomes will obviously depend on a number of factors, for example, investment returns.
- 1.10 Many people may want to save more. Contributions above the default minimum level from any people who do so would be eligible for tax relief (within existing rules and limits) but there will not be a requirement for an additional employer contribution.
- 1.11 Once personal accounts are up and running and a new employee already has a personal account from a previous job, the employee could be 'fast tracked' back into personal accounts. This would mean that contributions could be collected before the expiry of a fresh opt-out period (see Figure 1.4).

Figure 1.4: How automatic enrolment might work in practice



<sup>7</sup> Pensions Commission, 2005, *A new pension settlement for the twenty-first century: The second report of the Pensions Commission*, TSO.



## Who will be automatically enrolled

---

### Earnings band

- 1.12 From 2012, everyone with annual earnings above approximately £5,000 will be automatically enrolled, either into a personal account or an exempt work-based pension scheme. The lower earnings threshold of the PAEB ensures that all but the very lowest earners are automatically enrolled. Anyone can of course opt out if they do not feel they can afford to contribute. However, certain groups on low earnings will want to save. For example, some people will be second earners who can afford to contribute and most people do not stay on low incomes for the whole of their working life.
- 1.13 The minimum contribution will be 8 per cent of gross earnings within the PAEB and will comprise a minimum 3 per cent employer contribution, an employee contribution of around 4 per cent and a State contribution of around 1 per cent in the form of normal tax relief.
- 1.14 Employees with earnings within the PAEB who are not already contributing to an exempt pension scheme or automatically enrolled into their employer's scheme will be enrolled into a personal account. Employees with an annual income below the lower threshold of the PAEB may opt in to personal accounts and would receive tax relief on their savings. In this case, there is no requirement for an employer contribution to be payable.
- 1.15 After the first year of operation, the PAEB, on which personal account contributions are calculated, will be linked to annual earnings growth.<sup>8</sup> This will maintain the value of contributions to personal accounts in relation to earnings.
- 1.16 This will also ensure that personal accounts continue to reach those in our target group with moderate to low incomes. If the lower limit for personal accounts reduced each year in comparison to earnings, more very low earners would be brought into personal accounts when State benefits may already provide a retirement income which they may consider adequate.

<sup>8</sup> Uprating the PAEB in line with earnings, after the first year, is likely to uncouple the PAEB from the National Insurance thresholds. However, it will maintain the value of contributions to personal accounts in relation to earnings.

## Minimum age for automatic enrolment

- 1.17 The May 2006 White Paper stated that employees should be automatically enrolled into personal accounts from the age of 22. This is in line with when people become eligible for the National Minimum Wage main rate. Age 22 was proposed in response to concerns about the administrative cost associated with frequent job turnover among the young, particularly students, which might reduce incentives to hire younger workers. Research shows job turnover slows by age 22.<sup>9</sup> In addition, there is evidence that the employment of younger workers is more sensitive to non-wage costs, which is why the minimum wage has a lower rate below age 22. Selecting age 22 strikes the right balance between the age when job tenure becomes more stable and encouraging employees to start pension saving at an early stage. Employees below the age of 22 may opt in to personal accounts and receive an employer contribution on qualifying earnings.

## Maximum age for automatic enrolment

- 1.18 The May 2006 White Paper stated that employers would **continue to automatically enrol employees until they reach State Pension age**. The recent *Financial incentives to save for retirement* analysis<sup>10</sup> published in November 2006 shows that most people close to retirement can still expect a good payback from saving in personal accounts or an equivalent exempt scheme. The employer contributions and normal tax relief effectively double the individual's contributions going into their personal account, so even if they receive Savings Credit immediately on retirement, they should get back more than they contributed.
- 1.19 As with other age groups, there is a small minority of older people who are at risk of a smaller payback from saving. For example, people who expect to be claiming Housing Benefit in addition to Pension Credit and Council Tax Benefit in retirement, though these people may be able to increase their payback by taking their pensions as a lump sum.<sup>11</sup>

<sup>9</sup> Labour Force Survey, spring/summer 1997 to winter/spring 2004.

<sup>10</sup> *Financial incentives to save for retirement*, November 2006, [www.dwp.gov.uk/pensionsreform/pdfs/financialincentives.pdf](http://www.dwp.gov.uk/pensionsreform/pdfs/financialincentives.pdf)

<sup>11</sup> The tax rules allow pension funds of less than £15,000 to be taken as a lump sum. Subject to the capital rules in means-tested benefits (and any other savings), the fund could have no effect on benefit entitlement. In addition, because home ownership among older households is relatively high, they are less likely to be affected by Housing Benefit.

- 1.20 Some commentators have argued that when personal accounts are introduced there should be a lower age limit for automatic enrolment, as individuals within a few years of retirement will not have time to build large pension funds through personal accounts or equivalent employer schemes. Alternatively, people nearing State Pension age may well have already built up some savings, so the personal accounts savings would not be the only source of funds. Even if they have, provided they have total funds below the trivial commutation limit (£15,000 in 2006/07) they could take this as a lump sum.
- 1.21 We would welcome views on:
- Whether there should be a cohort of employees approaching State Pension age at the time personal accounts are launched who should not be automatically enrolled into personal accounts.
  - Whether in practical terms, this might adversely affect the interests of this group, because they would be less likely to exercise the positive choice to opt in.

### Re-enrolment

- 1.22 People's circumstances do not stay the same. Individuals may choose to opt out of personal accounts at the outset, perhaps because they do not believe they can afford to save. A year or two later, their circumstances could be completely different but inertia may prevent them from doing anything about it. The Pensions Commission recommended that employees who opt out should be automatically re-enrolled every three to five years. The treatment for exempt schemes is dealt with in Chapter 6, but we agree that **employees who have opted out of personal accounts should be automatically enrolled again periodically.**
- 1.23 The May 2006 White Paper stated that employees would be automatically enrolled when they change employers and every three years if they continued to work with the same employer. Research shows individuals recognise how quickly people's circumstances can change.<sup>12</sup> Therefore, three years seems the right period.
- 1.24 We would welcome views on:
- Whether three years is the right period for repeat automatic enrolment of employees who have opted out of personal accounts.
  - How this would affect employers and employees.

<sup>12</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

## Self-employed

- 1.25 There are around 3 million self-employed people in the UK, of whom around 2 million are not saving in a private pension. The self-employed will be able to participate in personal accounts on a voluntary opt-in basis.
- 1.26 The Government considered whether the scheme should set a minimum contribution level for the self-employed, to guide them towards an income replacement rate. However, given the changeable cash flow that some of the self-employed experience, individuals remain best placed to decide how much they should save in a personal account. Therefore, **self-employed people will be able to save in personal accounts at a level of their choosing**, subject to the cap on contributions which applies to all members.
- 1.27 It will be important to help the self-employed to think about the amount they wish to save. The information that supports personal accounts will need to include the key messages and issues that the self-employed might want to consider when making savings decisions.

## Economically inactive

- 1.28 It is important that people can continue to contribute to their personal account during periods out of paid work, if they wish to do so. The scheme is being designed with this in mind.

## Individual contributions

- 1.29 The May 2006 White Paper proposed a minimum contribution level of 8 per cent, in line with the recommendations of the Pensions Commission. This was set at a level aimed at achieving a replacement rate of about 45 per cent of pre-retirement income for a median earner as recommended by the Pensions Commission.
- 1.30 The extent to which people save beyond the minimum will depend on how much they can afford to save. However, this is only one factor that will be relevant. Individuals need to understand the benefits of saving more and the process of increasing contributions will need to be simple. This is something that the body responsible for personal accounts will need to consider. Further details on the remit of this body can be found in Chapter 3.

## Conclusion

---

- 1.31 Evidence shows that people have a tendency not to act when faced with difficult financial decisions. Automatic enrolment into a pension scheme has been shown to be one of the most effective ways of increasing pension saving, by introducing a presumption to save.
- 1.32 We propose that all employees between the age of 22 and State Pension age, with earnings above approximately £5,000 a year will be automatically enrolled into personal accounts or an equivalent work-based scheme.
- 1.33 The rate at which employees accumulate savings will be doubled thanks to matching their contribution of around 4 per cent, with a 3 per cent contribution from their employer and normal tax relief worth around 1 per cent.
- 1.34 Our goal is to develop a way that both encourages and makes it worthwhile for people to save for a pension, thereby giving them a reasonable expectation of being better off in retirement. We believe our proposals do just that.

## Questions for consultation

---

We would welcome views on:

- Whether there should be a cohort of employees approaching State Pension age at the time personal accounts are launched who should not be automatically enrolled into personal accounts.
- Whether in practical terms, this might adversely affect the interests of this group, because they would be less likely to exercise the positive choice to opt in.
- Whether three years is the right period for repeat automatic enrolment of employees who have opted out of personal account.
- How this would affect employers and employees.





## Chapter 2: Choosing the personal accounts model





## Chapter 2: Choosing the personal accounts model

The Pensions Commission proposed a National Pension Savings Scheme (NPSS) for delivering personal accounts. The Commission felt that, out of the various models they considered, the NPSS was the best solution as it offered low charges and simplicity for individuals and employers. The scheme would be arm's length from government.

The Government has undertaken a thorough evaluation of all the proposed alternative approaches for delivering personal accounts. This has revealed that each approach has advantages and disadvantages. Focusing on the needs of the target group shows that the NPSS approach would be the most effective delivery model.

This is because the NPSS:

- is the simplest model for individuals – balancing simplicity for the majority with choice for the significant minority who want it;
- delivers low charges – providers do not compete directly for individuals' accounts so there is less marketing expenditure and switching of accounts. Low charges will ensure larger pensions for scheme members; and
- minimises delivery risk – it is not a government model: instead, it utilises the skills, expertise and capacity of the private sector to develop, build and deliver personal accounts.

### The Pensions Commission proposals

---

- 2.1 The Pensions Commission proposed an independent, arm's length governance structure for delivering personal accounts, the NPSS. They recommended a non-departmental public body at the centre with its own board. The new body would be responsible for oversight of the new systems – collection, account administration and fund management – but would outsource these functions to the private sector.

- 2.2 In their report they also described a number of other possible delivery models. Whilst favouring the NPSS model, they did make clear that this was only a proposal, and would require further detailed analysis. Their proposal highlighted the importance of low cost and simplicity for the target group of individuals.

“There is a segment of the market, employees of average and lower earnings working in small and medium companies, plus many self-employed, which the retail financial services industry cannot serve profitably except at annual management charges which are disincentives to saving and which substantially reduce pensions available in retirement.”  
(Pensions Commission second report)

## Reaction to the Pensions Commission

---

- 2.3 The idea of personal accounts was welcomed. Most people recognised the need for a large-scale, low-cost scheme that could provide access to pensions saving for the large and growing group who did not belong to an existing employer scheme. The portability of the account – it could move with individuals as they changed jobs between employers who operate personal accounts – was seen as an important characteristic in a changing labour market. And the size of the scheme – they estimated that it would have between 6 and 8 million members – would help to reduce costs and drive down the high charges that many in the target group faced.
- 2.4 However, a number of stakeholders did not believe that the operational model proposed by the Pensions Commission was the right solution. They considered that it failed to use the existing pensions industry’s expertise and capacity.
- 2.5 As part of the National Pensions Debate, in December 2005 we set the pensions industry the challenge of coming up with a workable alternative using industry experience and capacity. We made clear that any alternative model would need to maximise participation among the target group and deliver a radical reduction in the annual management charge against existing pension products.

## May 2006 White Paper proposals

---

- 2.6 There was a lively response from the pensions industry to this challenge. A number of different operational models for delivering the new savings scheme were proposed. These were set out in detail in the May 2006 White Paper.

- 2.7 Based on extensive consultation, analysis and research with key groups, particularly employers and individuals, our evaluation allowed us to be clear on a number of areas of policy in the May 2006 White Paper.
- 2.8 **Employer choice** – some of the models we received required the employer to make a decision about what pension scheme their employees should join. In some cases the choice could be between large-scale trust-based schemes, in other models the employer chose between insurance providers.
- 2.9 Whilst some employers are keen to be involved in pension decisions, the research<sup>1,2</sup> shows that others, particularly smaller employers and those without current provision, tend not to want the burden of having to choose a provider. They do not feel equipped to make the decision for their employees and they do not want the burden of doing so. We also felt that employer designation undermined the principle of promoting personal responsibility.
- 2.10 **Establishing a clearing house** – analysis of persistency and job turnover showed that for any of the models to work effectively and efficiently, a central clearing house would be needed. Without a central body that collected contributions and information we would not be able to improve the persistency of saving, which is one of the key drivers of costs in the pensions market. Therefore, it was crucial that we improved the portability of pensions to help reduce costs.
- 2.11 **Managing the market** – we also concluded that the market would need to be simplified in some way. This was for two reasons:
- there are currently 26 stakeholder providers on the Financial Services Authority list<sup>3</sup> and it is very difficult for individuals to choose the right one for them. As complexity in pensions often leads to people disengaging, we need to ensure this does not happen with our target group; and
  - we need to achieve scale to drive down costs. Restricting the market would achieve the scale necessary to reduce costs.
- 2.12 On balance, our initial evaluation supported the NPSS approach over the industry alternatives. Industry argued that competition between branded providers would help drive down costs over time and lead to higher levels of service and better products. In addition, they argued that individuals wanted to have a choice about who administered their pension and that this decision would foster greater engagement and help people feel they had ownership of their pension.

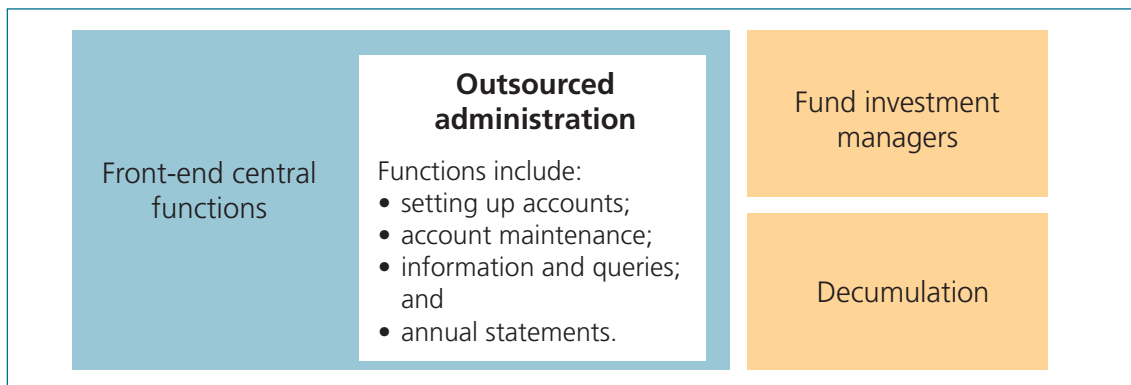
<sup>1</sup> Marshall H and Thomas A, 2006, *Employer attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 371.

<sup>2</sup> Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, *Employer attitudes to personal accounts: report of a quantitative survey*, DWP Research Report No 397.

<sup>3</sup> Malcolm K and Wilsdon T, 2006, *Competition in personal accounts*, CRA International.

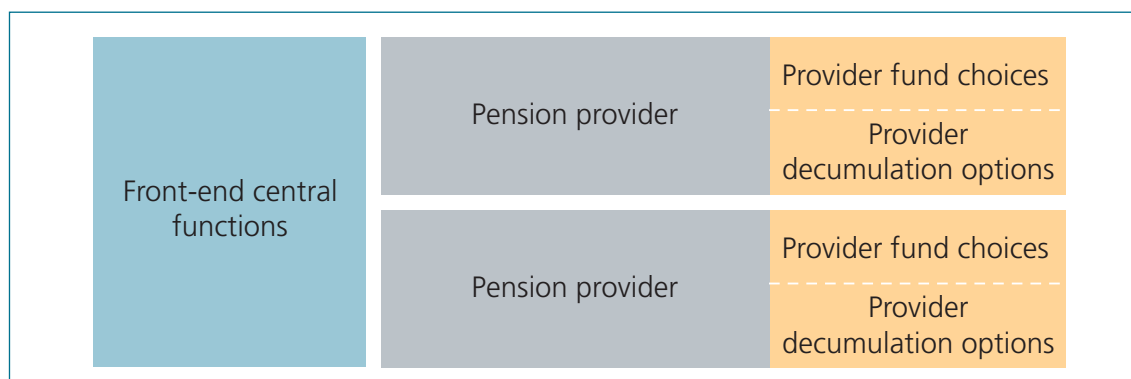
- 2.13 Further evidence on competition and choice and their impact on cost were essential to make a decision on the right model. Additional work was also needed to strengthen the business model and its costs, and to confirm the deliverability and financing arrangements for personal accounts.
- 2.14 The May 2006 White Paper outlined two distinct approaches to administering the new savings accounts:
- Option 1: the Pensions Commission’s approach – competition for contracts; and
  - Option 2: the alternative approach – competition through branded providers.

### Option 1: Competition for contracts – the NPSS approach



- 2.15 Personal accounts would be governed by a single organisation, which would organise the scheme in members’ best interests. The day-to-day running of the scheme would be outsourced to a number of pensions administrators. The NPSS would offer a limited choice of funds for savers and a default fund for those who do not choose a fund.
- 2.16 The Pensions Commission also suggested that, in addition to these funds, a further choice of non-centrally negotiated funds could be offered which would allow ‘alternative asset classes’ for those who wish to have a wider range of funds available.

### Option 2: Competition through branded providers – the provider choice approach



- 2.17 This model builds on existing pension provision. Enrolment, collection and processing of contributions would be similar to Option 1. Rather than one single organisation having oversight of the system, a limited number of pension providers would offer personal accounts and perform similar functions to those outlined for the outsourced administration in the NPSS model. Savers could choose one of these providers (or they would be allocated to one of them). Each pension provider would offer a selection of fund choices and decumulation options for retirement.
- 2.18 We asked for views on whether a model delivered through branded providers would benefit people. We were interested, in particular, in whether this approach added value for the individual or would give them greater confidence in the scheme. We also sought views on which scheme would lead to lower costs.

## Understanding the various approaches

- 2.19 Since May we have received proposals for a number of new models for delivering personal accounts. All of the models that we have received are variations on the approaches set out in the May 2006 White Paper but differ around a number of key areas:
- the level of choice for individuals – whether they should choose their administrator or their fund;
  - the extent to which administration and fund choice can be bundled together or offered by the same provider;
  - how many funds or administrators there should be; and
  - the consequences for those individuals who do not make a choice – whether they remain with a default provider or whether they are allocated to branded or unbranded providers.

- 2.20 The models that extended the choice for individuals were based on the principle that increased choice leads to increased competition. Increased competition in these models would, over time, drive down costs for individuals. They are described in Box 2a.

### Box 2a: Alternative approaches to delivering personal accounts

There were a number of proposed alternative approaches to delivering the personal accounts model. These were variants around the two main models outlined in the May 2006 White Paper. The variants on the NPSS approach were:

- **NPSS plus** – this is similar to the NPSS model. The individual is placed with an unbranded NPSS administrator if they make no active choice. However, if they wish they can choose an alternative administrator for their personal account from a shortlist of providers;
- **NPSS minus** – this is similar to the NPSS model, but there is no choice of fund – only the default is available; and
- **the provider choice minus** – this is very similar to the NPSS model except that the account administration is operated by branded pension providers. Funds are common across all providers so anyone not making a choice will get a common default fund but will be allocated to an administrator on a carousel basis.

The variants on the provider choice approach were:

- **the provider choice plus** – this is broadly similar to the main provider choice approach outlined in the May 2006 White Paper, though there would not be a limited panel of providers; any organisation able to deliver an appropriate service would be allowed to participate. This also provides an option where employers can, but are not required to, choose a default provider for their employees, which the individual has the right to override. If the employer does not select a default provider for employees, those not making a choice would still be allocated by carousel. The provider choice plus differs from the provider choice approach as there is unlimited choice and the employer has the option of choosing a provider; and
- **the hybrid provider choice** – this is a hybrid of the NPSS and provider choice approaches. Anyone not choosing an administrator would go into an unbranded provider with a common range of investment choices. Savers who wish to can make an active choice of branded administrator on an open-market basis. It is unlikely that those firms running the unbranded NPSS would also be offering branded choices.

## Evaluating the different approaches

---

- 2.21 A thorough evaluation of the possible delivery models has been undertaken. Full details are set out in the Regulatory Impact Assessment. This has involved working closely with the pensions and savings industry, consumer groups, employers and their representatives and other interested stakeholders.
- 2.22 This work aimed to:
- understand, in more detail, the processes involved in delivering personal accounts;
  - refine the costings and how these might feed through to the charging structure;
  - understand the potential financing regimes;
  - conduct further research and analysis around the impact of competition and choice;
  - understand more about international experience;
  - develop potential governance regimes;
  - understand more about the risks to individuals; and
  - understand the impact on the existing pensions market.
- 2.23 We are grateful to those in the pensions and savings industry who have helped us. They have provided us with information to enable us to build operational models of the different approaches to understand how they would work in practice. They have given us advice on potential financing arrangements and charging structures. In addition, we have held a range of seminars and workshops as part of our consultation, as well as many less formal meetings.
- 2.24 The work that has been done ensures that the decision on the delivery model is robust. It is important to remember what a significant reform this will be – a new way of saving for up to 10 million people. The scheme will collect contributions worth around £8 billion a year.

## Which model?

---

- 2.25 As the full evaluation in the Regulatory Impact Assessment makes clear, both the NPSS and a branded provider approach have a number of advantages and disadvantages. But focusing on the needs of the target group **we believe that the NPSS approach, overall, would be the most effective delivery model.** The NPSS:
- is the simplest model for individuals – balancing simplicity for the majority with choice for the significant minority who want it;
  - encourages competition – the personal accounts board will be able to negotiate contracts to ensure that charges for consumers remain low;
  - uses the skills, expertise and capacity of the private sector to develop, build and deliver personal accounts; and
  - is the model with lowest charges. As providers do not compete for individual accounts there is less marketing expenditure and switching of accounts.
- 2.26 The evaluation shows that the NPSS approach meets our key criteria of extending coverage, maximising participation and minimising costs.

## Maximising participation – providing individuals with the appropriate choice

---

- 2.27 Individual choice is normally the best way of allocating goods. In all the models, members will need to make a number of choices, including whether they should stay in the scheme and whether they should contribute above the default. Where the models differ is in decisions about investment and administration. In the provider model, individuals choose the provider they would like to administer their account. These providers are generally linked to fund managers who would invest individuals' funds.



- 2.28 Research evidence consistently indicates that many UK consumers find choices in pensions<sup>4</sup>, including investment fund choice<sup>5</sup>, overwhelming. This is one of the reasons why many do not choose to save voluntarily and are reluctant to seek information. This is particularly true of the target market. Evidence from both qualitative<sup>6,7</sup> and quantitative research<sup>8,9</sup> reveals a widespread lack of confidence among UK consumers in their ability to make decisions about pension provision. This lack of confidence is underpinned by low levels of financial capability, particularly among younger groups.
- 2.29 However, research indicates that a significant minority – perhaps up to 2 million members of personal accounts – may want extra choice among investment funds. Some younger respondents in particular mentioned a desire to have the choice to invest ethically. The inclusion of extra fund choice for those that want it could provide competitive pressure on the main investment funds as well as promoting personal responsibility amongst this group by encouraging higher contributions. Box 2b looks at our findings in more detail.

<sup>4</sup> WHICH?, 2006, *Pensions Research: qualitative research*.

<sup>5</sup> Hall S, Pettigrew N and Harvey P, 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>6</sup> Pensions Commission, 2005, *A new pension settlement for the twenty-first century: The second report of the Pensions Commission*, TSO.

<sup>7</sup> Hall S, Pettigrew N and Harvey P, 2006, *ibid*.

<sup>8</sup> Marketing Sciences, 2006, *Retirement Planning Monitor*, 2005.

<sup>9</sup> Research by the National Centre for Social Research and Stephen McKay for DWP (Clery E, McKay S, Phillips M and Robinson C, forthcoming in 2007, *Attitudes to Pensions: Findings from the 2006 survey*).

## Box 2b: Investment choice

The majority of the target group for personal accounts do not want to be faced with a choice over investments or administration of their pension, but a significant minority do. This minority tend to be younger or be higher earners, who have higher levels of confidence in their ability to choose and greater familiarity with financial choices.

**Consumers lack confidence to make investment choices** – evidence<sup>10,11,12</sup> reveals a lack of confidence among UK consumers about investment fund choice. This is compounded by low levels of financial capability, particularly among younger groups and with regard to financial product choice.<sup>13</sup>

**Too much fund choice can be confusing** – focus group discussions have suggested too much fund choice would make the scheme more complicated and confusing than it needs to be and that it would be likely to increase opt out rates.<sup>14</sup> Findings from the US 401(k) scheme<sup>15</sup> found that larger numbers of fund choices significantly reduced participation levels.

**Consumers want structured choice** – research indicates a shortlist of funds would provide choice for those who want it whilst minimising complexity, although overall no choice was generally preferred.<sup>16</sup>

**Choice needs to be appropriate** – research evidence shows that where consumers choose their own investment, a substantial proportion adopt a 'naïve diversification' strategy, in which money is divided equally among a number of funds irrespective of the underlying asset composition of the funds. So, consumers who do exercise choice may not necessarily make the right decisions.<sup>17</sup> Findings also show that investments are influenced by recent returns in the market, implying that the timing of the launch of the programme can have a strong impact on the asset allocations of the participants. This effect can be long-lasting because very few participants have altered their portfolios.<sup>18</sup>

<sup>10</sup> Hall S, Pettigrew N and Harvey P, 2006, *ibid.*

<sup>11</sup> Hall S, Pettigrew N and Harvey P, 2006, *ibid.*

<sup>12</sup> Marketing Sciences Ltd, 2006, *Retirement Planning Monitor 2005.*

<sup>13</sup> Atkinson A, McKay S, Kempson E and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, FSA Consumer Research Report No 47.

<sup>14</sup> Hall S, Pettigrew N and Harvey P, 2006, *ibid.*

<sup>15</sup> Iyengar SS, Jiang W and Huberman G, 2003, *How much choice is too much? Determinants of individual contributions in 401(k) retirement plans*, Wharton Pension Research Council.

<sup>16</sup> Hall S, Pettigrew N and Harvey P, 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>17</sup> Benartzi and Thaler, 2001, *Naive diversification strategies in defined contribution saving plans*, *The American Economic Review*, 91(1): 79–98.

<sup>18</sup> Cronqvist and Thaler, 2004, *Design choices in privatized social-security systems: Learning from the Swedish experience*, *American Economic Review*.

This underlines the importance of a default fund for those who do not want to make these choices.

**The benefits of choice** – the industry has argued that having choice will promote personal responsibility and drive higher participation rates and contribution rates. Research from US defined contribution schemes found that a participant who has a choice of investments contributes over 8.5 per cent more into the scheme than a comparable participant without choice.<sup>19</sup> Having a choice also allows customers to switch, Oxera find that some degree of switching is desirable since it “...creates conditions for competitive pressure on pension providers to reduce costs and improve their customer service and product offerings”.<sup>20</sup> CRA International<sup>21</sup> also find that switching exerts some pressure on providers, although for this to be successful depends, to a large extent, on customers becoming more financially sophisticated than they are currently.

#### Administrator choice

**Choice of administrator does not appeal to target market** – DWP research suggests that savers, especially those earning less than £30,000 a year, prefer not to make a choice of administrators over having to choose from a panel or open market.<sup>22</sup> Evidence<sup>23</sup> provided by the industry shows that some less financially aware consumers expressed concerns about having to make a choice of provider, which they considered daunting, and might put them off participating. Higher earners felt that they had the necessary aptitude to make decisions such as this and felt that choice could have benefits for them. Research also suggests that a default option would reduce the burden on consumers who did not want, or were unable, to make a choice.<sup>24</sup>

- 2.30 All of the analysis points to the need for a successful model to: maximise simplicity; not require the majority to make decisions they find overwhelming; and provide choice for the significant minority who want it. This is one of the central reasons why we are proposing the NPSS model over a branded provider approach.

<sup>19</sup> Papke L, 2004, *Choice and other determinants of employee contributions to defined contribution plans*, Working Paper, CRR WP 2004–06. The sample used in this survey was all aged 51–61 with an average age of 54.

<sup>20</sup> Oxera, 2006, *How to evaluate alternative proposals for personal account pensions: An economic framework to compare the NPSS and Industry models*, commissioned by the ABI.

<sup>21</sup> Malcolm K and Wilsdon T, 2006, *Branded choice in personal accounts*, CRA International.

<sup>22</sup> Hall S, Pettigrew N and Harvey P, 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>23</sup> Malcolm K and Wilsdon T, 2006, *Branded choice in personal accounts*, CRA International.

<sup>24</sup> Hall S, Pettigrew N and Harvey P, 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

- 2.31 Only an NPSS model can deliver the simplicity and protection for the majority. The independent governance arrangement can ensure the scheme is run in the interests of its members; ensure there is an appropriate default fund; and enable those who want extra choice to have it, maximising contribution rates and participation levels (see Chapter 5).

## Minimising charges in the scheme

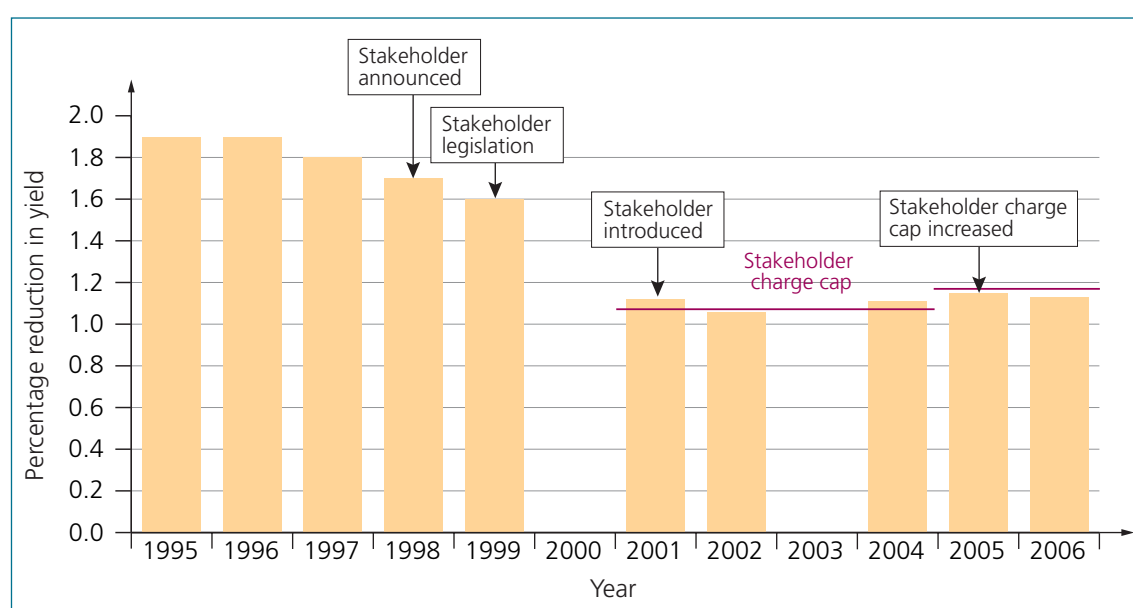
---

- 2.32 The May 2006 White Paper made clear that achieving scale was important in driving down costs. Our analysis shows that both the NPSS approach and a restricted market for branded providers will achieve the maximum scale possible. This is backed up by the Association of British Insurers' (ABI's) analysis.<sup>25</sup>
- 2.33 Costs can be affected by other factors, most notably competition, the need for advice or regulation of sales, and whether the models provide extra functions that add to cost.
- 2.34 Both the NPSS and provider choice approaches are competitive models, but how competition works in them is different. In the NPSS approach, the board takes responsibility for agreeing contracts with companies, be they administrators or fund managers. The board acts in members' interests and tries to ensure the best outcomes for them. In all the provider models, companies compete to get individuals to join their scheme. As people can switch between providers they can move to one with the lowest charge or the best service according to their judgement.
- 2.35 This argument only works if individuals are well informed about the market. They would need to be able to see which is the best provider or the best fund. Evidence suggests the target group are not well informed about this particular market. They find pensions confusing: they shy away from making decisions and their concern about making the wrong choice often means that they do not make any.
- 2.36 We have considered the competitive impact of each model in some depth. We do not believe the arguments are conclusive for either an NPSS or a provider choice model, but evidence shows that in the current pensions market competition does not always work to the customer's benefit.

<sup>25</sup> ABI, 2006, *How to evaluate alternative proposals for personal account pensions: An economic framework to compare the NPSS and Industry models*, research carried out by Oxera.

- 2.37 The Sandler review showed that there was little evidence that choice and competition in the pensions market drove down costs. The Pensions Commission<sup>26</sup> showed that the reductions in charges that many people now benefit from were caused by regulatory changes – such as the introduction of stakeholder pensions and changes in the charge cap – rather than competitive forces. Figure 2.1 demonstrates the impact of regulation on charges over time.

Figure 2.1: Impact of regulation on charges over time



Source: FSA disclosure reports and comparative tables

- 2.38 We know that the provider choice model has additional costs which are not in the NPSS model. Because firms compete directly for consumers, they have marketing costs which are not borne in the NPSS model. In addition, the costs of switching accounts as a result of successful marketing can be significant. If these costs help drive competition and, in turn, drive down charges then these initial costs would benefit individuals in the long run. But we are not confident that competition will work in this way in personal accounts.
- 2.39 Our analysis suggests that the marketing and switching costs, which are not present in the NPSS model, could make the branded provider models about 20–25 per cent more expensive. Box 2c looks at the impact of competition on costs and whether it could drive down this difference in cost.

<sup>26</sup> Pensions Commission, 2004, *Pensions Challenges and Choices: The First Report of the Pensions Commission*, Appendix C.

- 2.40 Our objective is to minimise the charges faced by individuals. The Pensions Commission suggested that the NPSS model could be delivered for an annual management charge of 0.3 per cent in the longer term. The Commission's proposal did not include the costs of monitoring automatic enrolment and it assumed that costs would be recovered over an individual's full working life. However, our analysis indicates that it would be possible to achieve a substantial reduction in the cost of providing personal accounts for our target group, possibly as low as 0.5 per cent in the short term and below 0.3 per cent in the long term, even taking into account the likely need to finance the scheme over a shorter timescale and including the cost of compliance. This gives the NPSS model a strong advantage over provider choice models.

### Box 2c The impact of competition on costs

Our analysis suggests the NPSS approach would have costs that are 20–25 per cent lower than a provider choice model. We look here at whether competitive activities could reduce the cost differential:

**Could the competitive activities of providers increase participation in the provider choice model?** – participation would have to be at the optimistic end for the provider choice model and at the pessimistic end for the NPSS model – participation would have to be twice as high in the provider choice model for it to have lower charges than the NPSS model.<sup>27</sup>

**Could competitive activities of providers increase contributions in the provider choice model?** – contributions would have to be nearly 25 per cent higher (10 per cent as opposed to 8 per cent on average) in the provider choice model for it to have the same charges as the NPSS model. Whilst we believe that providers may have a greater incentive to engage customers with their accounts (since the providers derive a financial benefit from doing so) this effect is unlikely to be significant enough to result in the required increase in contributions. US evidence<sup>28</sup> suggests that there is a "...tendency of employees to stick with the default" at least in the short term. Often the most effective method of increasing contributions is through pre-commitment – a mechanism which could be used within NPSS or in other models.<sup>29</sup>

<sup>27</sup> DWP research indicates that provider choice might lead to confusion and therefore, increased opt-out. Hall S, Pettigrew N and Harvey P, 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>28</sup> Choi et al, 2001, *Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance*.

<sup>29</sup> For an example, see Benatzi S and Thaler R, 2003, *Save More Tomorrow: Using Behavioural Economics to Increase Employee Saving*.

**Could competitive activities of providers in the provider choice model lead to a higher level of cost reduction over time than the NPSS model?** – costs in the provider choice model would have to increase at **3 per cent less than inflation** for it to have the same charges as NPSS models or finance costs would have to be 25 per cent higher in NPSS models (11 per cent cost of capital compared to 14 per cent) to mean that charges are the same for both models. There is no evidence that finance costs within a provider choice model would be cheaper than in an NPSS model.

Competition may drive down costs within a provider model, and we believe that these models could be more competitive on a daily basis than NPSS, where there will be a periodic competition for contracts.<sup>30</sup> However, within any model a 3 per cent real fall year-on-year<sup>31</sup> over a 25-year period is unlikely to be readily achievable (especially given that a share of the costs will be labour costs which are likely to grow faster than inflation). Even if it is possible, there is a further difficulty in ensuring the reduction in costs benefits the consumer<sup>32</sup> rather than the providers.<sup>33</sup>

- 2.41 Chapter 3 outlines plans for the delivery authority for personal accounts and the final governance structure. The scheme will be set up from the start to have independence from the Government. We will use expertise from the private sector, where there are the skills required to establish such a scheme.

<sup>30</sup> Malcolm K and Wilsdon T, 2006, *Competition in personal accounts*, CRA International – they conclude that inertia within the target group may mean competition will not work as providers will have low incentives to compete in terms of price and service. Therefore, competition in an open market will not necessarily work better than competition for the market in a panel setting. In order to maintain dynamic efficiency (competition in the long run), any limited panel needs to be updated at intervals, but this is easier with unbranded funds as consumers will not notice changes in providers: however, this may lose any positive effect of established brands.

<sup>31</sup> In the case of lower participation in a provider model, or where there is a requirement for a regulated sale, then the relative decline in costs would need to be even greater than a real fall of 3 per cent year on year.

<sup>32</sup> Malcolm K and Wilsdon T, 2006, *Competition in personal accounts*, CRA International. CRA looked at the economies of scale in fund size required to reduce costs and found that: "...given behaviour of consumers in the target market, it is likely that this part of the market will be insensitive to price and the time taken for market discipline to result in consolidation to an efficient number of providers could be significant."

<sup>33</sup> Sandler R, 2002, *Medium and long-term retail savings in the UK: A review*, HM Treasury. The example of personal pensions is pertinent in that here, regulation (through RU64 and the stakeholder charge cap) appears to have been far more effective in reducing charges than competition. The Treasury's review of the competitive process in the retail long-term savings industry (Sandler Review) in 2001 concluded that: "Price competition in the industry is not intense. Consumers find prices extremely difficult to assess and may in fact not even be conscious of the concept of "price" for a savings product."

## Conclusion

---

- 2.42 We have consulted on a range of model and process options and looked at financing and charging structures. Our analysis of these options, and the responses we received through consultation, gives us confidence that personal accounts is a model that can be delivered in a way that will work for all the interested parties – Government, employers, existing providers and, most importantly, for the individuals who through it will save for their retirement.
- 2.43 We will deliver personal accounts through an NPSS approach. The extensive evaluation shows that it is the model that maximises participation, by providing a simple effective scheme and minimising costs.





Chapter 3:  
Delivering personal accounts



## Chapter 3: Delivering personal accounts

Effective governance of the personal accounts scheme is essential for long-term sustainability and credibility.

Personal accounts will be delivered using private sector expertise, working within a remit set by the Government with members' interests at its core.

The Government plans to do this in three stages:

- setting up an advisory delivery authority to develop the commercial and procurement strategies;
- extending the remit of this body to take on executive powers to negotiate contracts and construct the personal accounts scheme; and
- transition to the personal accounts board to run the scheme from launch.

The Government is consulting on the most effective methods of member representation.

“Consultation with CBI members indicates they support a private sector solution for administering the transfer of money from employees and employers into personal accounts regardless of which model the Government chooses to adopt.”  
(Confederation of British Industry)

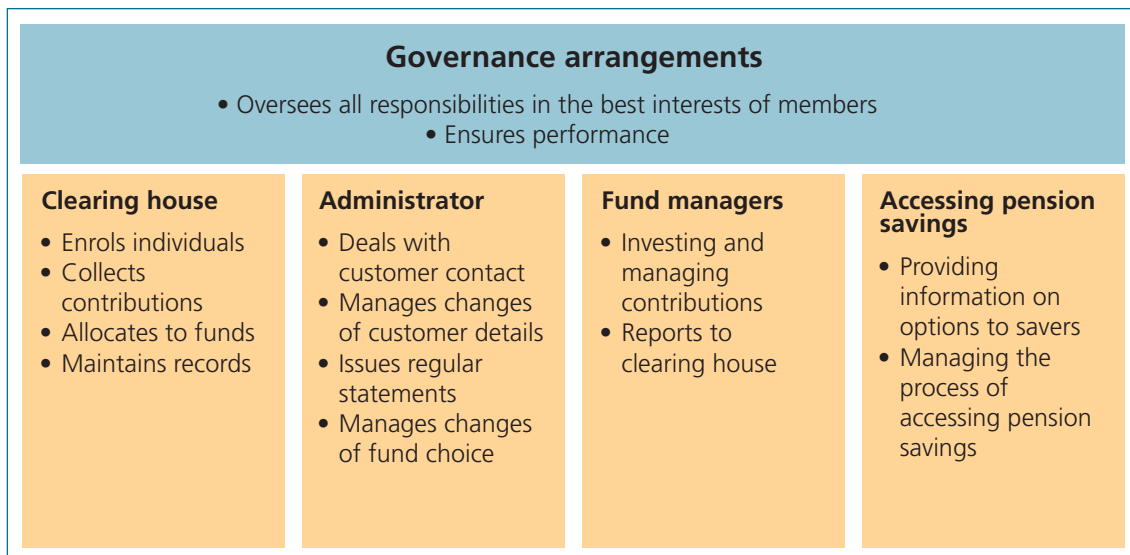
- 3.1 Managing a major occupational pension scheme such as personal accounts, with up to £8 billion in contributions a year from millions of savers, should not be a task for government. There is a wealth of relevant expertise in the private sector. We need to draw on this expertise to build the organisation that will deliver and run personal accounts. We want an organisation that is independent of government, run for its members and delivered by the private sector.
- 3.2 People need confidence that their money is being managed responsibly and that members' interests are at the heart of the system. Stakeholders across industry, and employer and consumer representatives all agree that harnessing the skills and expertise of the private sector to deliver personal accounts within a framework specified by government will allow the scheme to build credibility and public confidence. This is the approach the Government intends to take.

## Organisation structure

---

3.3 Chapter 2 explained the Government’s choice of the NPSS approach as the best way to deliver a low-cost, portable account for the target group. The full details of what this will mean in practice will be refined as the policy and commercial processes are developed further. It is clear, however, that four key functions will be central to successful delivery: the clearing house, account administration, fund management and accessing pension savings. These are represented in Figure 3.1.

**Figure 3.1: Organisational structure**



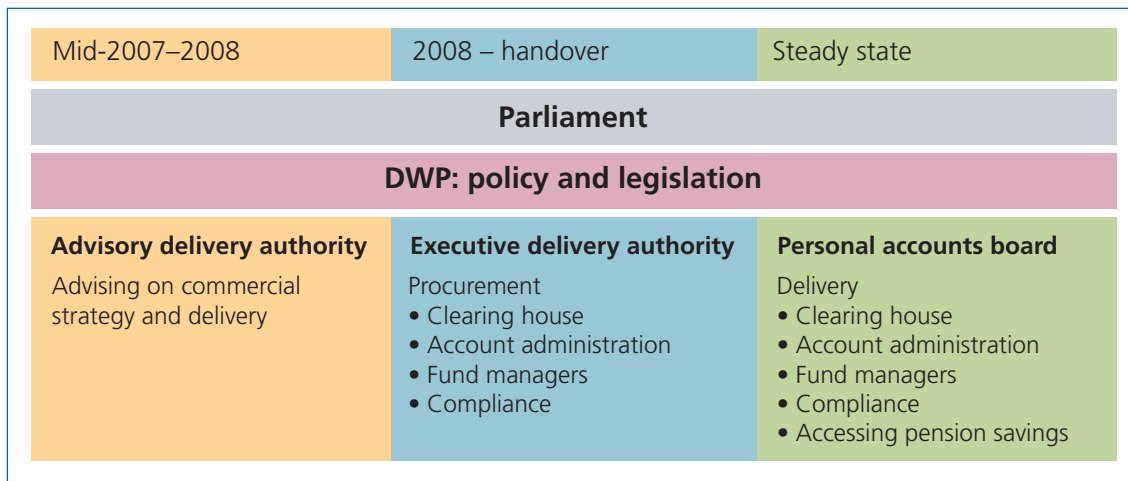
3.4 All of these processes and underpinning systems exist already in the private sector. The Government anticipates that some companies will focus on delivering one part of the process, for example fund management: others will provide an end-to-end service for investors. Their expertise will be essential to help build the personal accounts system and then to run it effectively.

## Creating personal accounts

---

- 3.5 There is a huge amount of work to be done before personal accounts can be introduced. It is essential to bring in private sector expertise at an early stage. The Government wants to ensure that the financial, commercial and operational implications are fully understood, and the most effective systems and structures are put in place to deliver personal accounts.
- 3.6 The work falls broadly into three stages:
- **Stage 1** – finalising the detailed policy design and developing a commercial and procurement strategy within the framework set by legislation.
  - **Stage 2** – implementing the commercial and procurement strategy: design, build and test of systems.
  - **Stage 3** – managing a fully operational personal accounts scheme.
- 3.7 The Government proposes an organisational structure to deliver personal accounts which will reflect this three-staged approach. **In the Pensions Bill introduced on 28 November 2006, we have included powers to set up a personal accounts delivery authority.** This will act initially in an advisory capacity on the detailed scheme design and the commercial and procurement strategies. It will be led by a chairman and chief executive, recruited almost certainly from the private sector, with the necessary skills to oversee the setting up of a financial institution. They will be supported by appropriate legal, commercial, operational, business and financial expertise.
- 3.8 The Government intends to introduce a second pensions Bill in a later session which will include the detailed provisions on personal accounts. **It will also include powers for the advisory delivery authority to take on an executive role, reporting to Parliament through the Secretary of State.**
- 3.9 This second, executive stage of the delivery authority will be followed by the establishment of the personal accounts board which will be responsible for all aspects of running the personal accounts scheme from launch. Figure 3.2 sets out the different responsibilities for each stage.

Figure 3.2: Responsibility for personal accounts



3.10 Legislation to set up the advisory delivery authority is included in the Pensions Bill introduced on 28 November 2006. The intention is that people will be recruited to key leadership positions, including the chair, chief executive and commercial director, by mid-2007. The remit for this stage of the delivery authority will be:

- providing advice and making recommendations – supporting the Government in understanding the operational and commercial implications of policy options; and
- developing the commercial strategy – taking forward the financial, technical and commercial development work prior to commencement of the procurement process.

3.11 The proposed second Bill will include powers to give the advisory delivery authority executive powers. This is expected to allow the authority to enter into formal negotiations, finalise contracts, and manage the development of the systems and structures needed before the scheme can go live. The delivery authority will finalise commercial contracts, create the infrastructure for personal accounts, design the investment strategy and take full responsibility for the delivery of the scheme.

3.12 During this second stage the delivery authority is likely to be responsible for:

- procurement – commercial contracting that will create the infrastructure for personal accounts;
- project management – responsibility for programme delivery and management of delivery against targets;
- design and development of the investment strategy – agreeing the statement of investment principles, determining the level of choice available to members, designing the default fund and contracting with fund managers;

- engaging with stakeholders – working with stakeholders across government, industry, employers and consumers to ensure that delivery remains focused on the objectives for the target group;
  - marketing and communications – designing and developing information and marketing strategies; and
  - setting up the most effective arrangements to ensure constructive engagement with members.
- 3.13 The second Bill will also set out the legal framework for governing the scheme after launch. It will include the objectives and statutory requirements of the personal accounts board. Within this framework the organisation will have the flexibility to deliver the scheme in the best interests of its members.
- 3.14 The delivery authority will be subject to the normal scrutiny and accountability arrangements, providing an annual report and accounts to the Secretary of State for Work and Pensions, who will lay these before Parliament.

## The personal accounts board

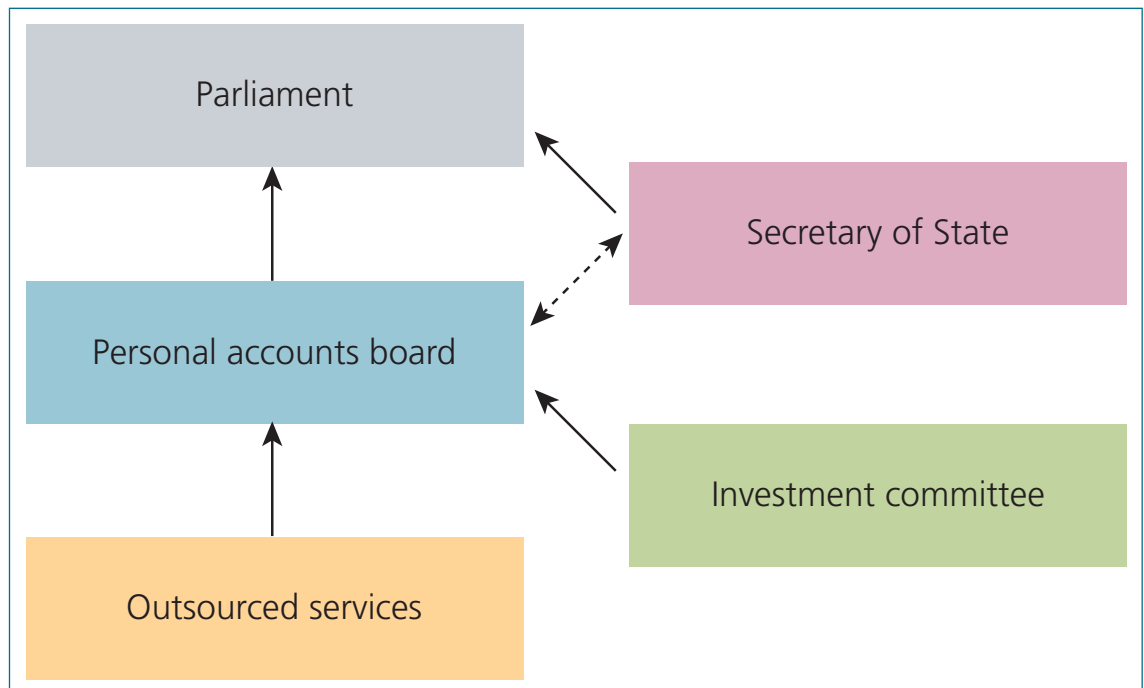
---

- 3.15 **At the third stage, a personal accounts board will be established to be responsible for the management of personal accounts.** There is a clear distinction between the work of the delivery authority and the personal accounts board. For instance, the delivery authority with executive powers, is likely to be responsible for designing the investment strategy which will be in place when personal accounts are launched, whereas the personal accounts board is likely to be responsible for regularly reviewing that investment strategy, in the light of participation rates, evaluation of evidence on how the scheme is operating, and feedback from members or their representatives.
- 3.16 The Government anticipates that there may be an overlap period during which the delivery authority and the personal accounts board are both in place, so that the delivery authority can address any operational issues which arise around the time of the launch. The full personal accounts board structure has yet to be determined but it will comprise executive and non-executive members responsible for ensuring the delivery of the scheme's objectives.

- 3.17 The objectives of the scheme will be set in statute and are likely to include:
- optimising levels of participation and contribution among the target group;
  - setting an investment strategy in the best interests of members;
  - minimising burdens on employers;
  - considering the impact on other high-quality pension provision;
  - assuring security of administration;
  - governing in the best interests of members and beneficiaries;
  - ensuring that the board acts impartially, prudently, responsibly and honestly;
  - delivering appropriate levels of choice;
  - achieving both the lowest possible charges for members and charges that are fair between members; and
  - ensuring that funds are invested in the best interests of the members.
- 3.18 The personal accounts board will also ensure that the needs and requirements of individual groups, for example women, within the wider target group are considered.
- 3.19 The board will be responsible for three distinct areas:
- setting the **strategic direction** of the scheme and how the objectives set by government will be achieved;
  - **overall management of the scheme** – oversight of scheme delivery; monitoring levels of service to members; setting standards for collection; verification and payment; and information to members; and
  - **investment strategy** – ensuring that contributions are invested in the best interests of members; deciding on the range of choice available to investors; the strategy for investment of the default fund; and appointment and management of fund managers.



Figure 3.3: Governance structure



- 3.20 It is anticipated that the personal accounts board will be a body corporate, established under statute and self-financing. It will be subject to the normal scrutiny and accounting procedures, accountable to Parliament and will provide an annual report and accounts (see Figure 3.3). The board will be responsible for employing its own staff: it is expected that this will not be a large organisation as most of its functions will be contracted out.

## Member representation

- 3.21 The Government has decided on the NPSS approach for personal accounts because it believes that this approach best meets the needs of the target group. It will be essential to the success of the scheme that members' needs remain at the core of operational decision-making and are fully considered in the development of investment strategy, additional levels of choice and the charging structure.
- 3.22 Best practice in engaging with consumers is an area that is developing rapidly. It would not be wise to try and anticipate now what might work best when personal accounts are introduced. The success of the National Pensions Day in March 2006 showed that it is possible to engage people in debating the future of pensions, usually considered too dry to capture the interest of the average person.

- 3.23 The Government believes that requiring the board to be open and consultative and to act in the interests of its members is the minimum level of engagement required. Options could include representation on the board (with non-executive members of the board tasked with representing the interests of individual members, employers and other stakeholder groups) or a stakeholder advisory body, with the board required to consult this body at regular intervals or when making significant changes to the structure of the scheme.
- 3.24 The delivery authority, and subsequently the board, will be tasked with setting up the most effective arrangements to ensure constructive engagement with members. In the meantime we would welcome views on which structure would best ensure members are effectively represented.
- 3.25 **The Government is interested in views on how members' interests can best be represented in the governance of personal accounts.**

## Information

---

- 3.26 All stakeholders agree that providing good quality information will be critical to the success of personal accounts. It is too early to specify the details of the information products linked with personal accounts – and this is an area where the Government will need to work closely with the delivery authority – but early development work shows that different parties will require the following types of information:

### employees:

- understand automatic enrolment and possible reasons for opting out, such as high levels of debt or short-term residency in the UK;
- be aware of their right to join a pension scheme (if eligible) and to receive an employer contribution;
- understand the initial choices to be made, particularly:
  - whether to opt out;
  - whether to invest more than the minimum;
  - what fund to invest in;
- understand the broader context before making long-term saving decisions;
- the level of savings accumulated and what this means for retirement income;
- options for accessing pension savings;

**employers:**

- understand how the scheme will work, their obligations under personal accounts and the importance of compliance;
- have access to any support they might need to help them meet their obligations;

**the self-employed:**

- understand the option to enrol in personal accounts and how it could benefit them to opt in;
- support in deciding on a contribution level;
- the same choices on saving and accessing pension savings as employees;

**third party/intermediary organisations:**

- information ahead of scheme introduction so that they can support their service users.

- 3.27 A number of organisations are involved in communicating information about pensions, including the DWP, the Financial Services Authority, the Pensions Advisory Service and organisations in the voluntary sector. We will be working with these groups to develop an evidence-based information strategy for pensions and personal accounts over the next year.
- 3.28 This work will be developed in the context of the financial capability strategies, led by the Financial Services Authority and HM Treasury, and will draw on ongoing and future DWP research including:
- nationally representative surveys of public attitudes to personal accounts, (covering likely reactions and information needs), and to pensions and planning for retirement; and
  - in-depth qualitative research exploring information needs in the context of personal accounts; individuals' understanding of pension forecast information; and young people's attitudes to saving.
- 3.29 The Government would welcome views on what sort of information should support personal accounts, and the responsibilities of different organisations in communicating this information.

## Conclusion

---

- 3.30 The new personal accounts scheme is a significant reform of the welfare state. Robust technical design, effective delivery and good governance are all vital to the credibility and sustainability of this new system.
- 3.31 The proposals for personal accounts have been developed through extensive consultation with the private sector, and personal accounts will be delivered using private sector expertise working within a statutory remit set by government, with members' interests at its core. The Government proposes a three-staged approach to achieve this:
- setting up an advisory delivery authority to develop the commercial strategy, powers for which will be taken in the Pensions Bill currently before Parliament;
  - extending the remit of this body, in a later session, to take on executive powers, system specification and development, and negotiation and management of the contracts which will create the personal accounts scheme; and
  - managing a fully operational personal accounts scheme.
- 3.32 The delivery authority and the personal accounts board will both be subject to the normal scrutiny and accountability arrangements, providing an annual report and accounts to the Secretary of State, who will lay these before Parliament.

## Questions for consultation

---

The Government is interested in views on how members' interests can best be represented in the governance of personal accounts.

The Government would welcome views on what sort of information should support personal accounts, and the responsibilities of different organisations in communicating this information.



## Chapter 4: Charges and financing



## Chapter 4: Charges and financing

High charges reduce people's pension incomes. Personal accounts will be designed to be a low-cost, good-value way to save.

The Pensions Commission suggested that an annual management charge of 0.3 per cent was achievable. The Government believes that this is possible in the long term, and that in the short term, charges will be comparable with the Commission's estimate when this is adjusted to take account of the likely need to finance the scheme over a shorter timescale, and the need to operate a light-touch but effective compliance regime.

The Government is, therefore, confident that personal accounts can achieve a radical reduction in pension charges, even in the short term, making a real difference to people's pension outcomes. The personal accounts board will be tasked with delivering low costs to its members.

"The Government and Pensions Commission have rightly emphasised that the costs of administering and investing contributions in personal accounts should be kept as low as possible, to enhance the returns achieved by consumers on their savings."

(Association of British Insurers)

- 4.1 Through personal accounts the Government aims to provide people with a simple low-cost way of pension saving. This means that the charges for personal accounts will need to be kept as low as possible. The Pensions Commission suggested that an annual management charge of 0.3 per cent would be achievable in the long run. The level of charges will depend on a number of factors which include the financing regime and the charging structure. These are explored further in this chapter.

### Importance of low charges

---

- 4.2 Low charges mean that, for a given rate of pension contribution and fund growth, more money is accumulated in an individual's pension fund each year. Consequently, more growth is accrued and compounded each year, ultimately resulting in a larger pension fund and a larger pension income on retirement.
- 4.3 For example, using an annual management charge (AMC) structure<sup>1</sup>, an apparently small decrease in the charge has a disproportionate impact on the level of the final fund. For example, a decrease in the AMC from 1.5 per cent to 0.5 per cent over an individual's working life can mean a 25 per cent increase in fund size.

<sup>1</sup> An AMC is a charge made on the proportion of an individual's fund size.

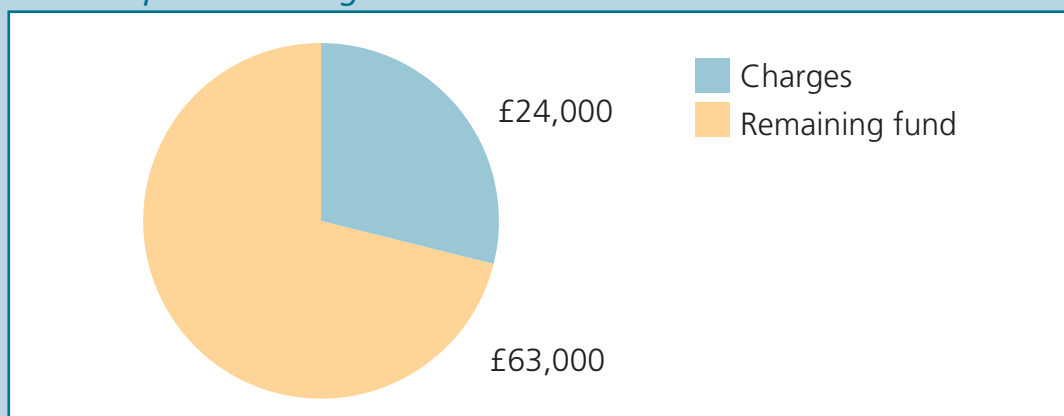
- 4.4 Low charges will make a significant difference to the majority of the target group for personal accounts who, up until now, have not had access to a pension scheme with low charges.

### Box 4a: Impact of charges

For a male median earner (£23,000 a year) aged 25 in 2012 who saves in a pension for 43 years<sup>2</sup>, under a 1.5 per cent AMC, his pension fund at retirement is worth £63,000<sup>3</sup>, meaning that £24,000 of his fund has been lost in charges.<sup>4</sup> Under a 0.5 per cent AMC, his pension fund is worth £78,000 and £9,000 is lost in charges. This individual's pension fund is, therefore, approximately 25 per cent larger purely as a result of the lower charge. This pattern of variation across charges is similar for all earnings levels, although the absolute size of pension funds vary proportionately according to different income levels.

Figure 4.1: How higher charges reduce the pension fund size of a median earner (£23,000) who saves for 43 years

*For a 1.5 per cent charge*

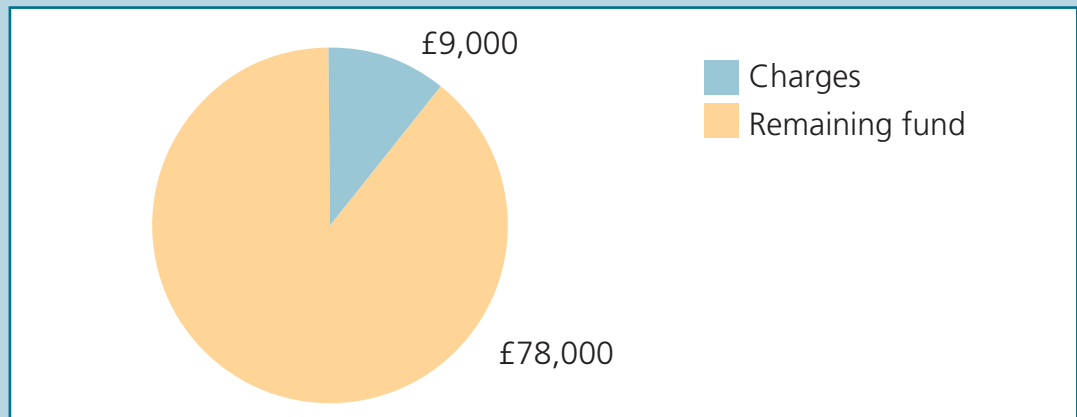


<sup>2</sup> In this analysis we assume that there is no relationship between the AMC and the returns achieved by fund managers for investors. 'Active' fund managers usually charge much higher fees compared with 'passive' fund managers, but evidence to date suggests that both types of fund manager achieve a similar rate of return. Research in this area continues.

<sup>3</sup> The figures provided are in 2006/07 earnings terms.

<sup>4</sup> The amount lost in charges was calculated as the difference between the fund size under the relevant charge compared to what the size of the fund would be under a zero charge.



*For a 0.5 per cent charge*

Source: DWP modelling

Notes: The amount lost through charges was calculated as the difference between the pension fund size under the relevant charge compared with what the fund size would be under a zero charge.

Assumes a total contribution rate of 8 per cent, and nominal pension fund growth of 6.47 per cent a year (3.5 per cent real).

Figures have been rounded to the nearest £1,000.

The figures provided are in 2006/07 earnings terms.

It should be recognised that the actual funds, and the charges paid by members, will be influenced by many factors including fund growth, the source and terms of finance, participation, contributions, choice of funds, the charge structure and operational costs of the scheme, all of which are difficult to predict at this point. They do not represent actual outcomes for members.

This figure is for illustrative purposes only. It should not be used as the basis for individual decisions as specific circumstances or variation from the underlying assumptions will lead to different results.

## Would an annual management charge of 0.3 per cent be achievable?

- 4.5 The Pensions Commission report concluded that its proposed National Pension Savings Scheme (NPSS) could be run at an AMC of 0.3 per cent in the long term. Our analysis indicates that in the long term it would be possible to run personal accounts at a charge of, or possibly even below, the 0.3 per cent level. In the short term, charges will be comparable with the Commission's estimate when this is adjusted to take account of the likely need to finance the scheme over a shorter timescale, and the need for a compliance regime.

- 4.6 The key differences between this analysis and that of the Pensions Commission are that the Commission:
- did not include in the charge, the costs of monitoring the requirement for employers to automatically enrol their employees into personal accounts and make the required contributions; and
  - assessed the viability of personal accounts over the average working life of an individual. This meant that costs could be spread over a very long period of time. In reality, organisations financing the scheme are unlikely to accept losses for long periods on the understanding that they may only receive money decades later.
- 4.7 The work the Government has done indicates that, in comparison with existing pension products, personal accounts would achieve a substantial reduction in charge levels for our target group. The Government believes that personal accounts could deliver an AMC possibly as low as 0.5 per cent in the short term and below 0.3 per cent in the long term. This contrasts with a stakeholder charge cap of 1.5 per cent in the first ten years, falling to 1 per cent thereafter.
- 4.8 **The Government is confident that charges in the scheme can be radically lower than those currently offered to our target group.** However, the exact charge cannot be estimated with certainty. The charges faced by individuals in personal accounts will be determined by factors that, at this stage, cannot be predicted with great certainty, including:
- financing of up-front costs and early operating losses;
  - participation and contribution levels of individuals; and
  - administration and fund management costs, which will be revealed by the commercial process.

### Box 4b: International evidence for charges reducing over time

International evidence shows that it is possible to achieve both substantial reductions in charges compared to the current charges in UK stakeholder pension schemes and substantial reductions in administration costs over time.

#### US Thrift Savings Plan

The Thrift Savings Plan is a scheme for government employees with typically high earnings and infrequent job moves, and deals with a small number of employers who operate a common payroll structure. Whilst not directly comparable with personal accounts, the scheme has significantly reduced its charges since its creation in 1988.

Charges in the Thrift Savings Plan started at around 0.35 per cent in 1988 and reduced to 0.07 per cent by 2003. Thereafter, the charges have reduced by 0.01 per cent every year.

#### Sweden

The Swedish Premium Pension Scheme (PPM) currently has a total charge of about 0.37 per cent for those in the default fund. The average charge for those in non-default funds is 0.64 per cent.

Looking forward, it is anticipated that the total charge for actively managed funds will be reduced to 0.33 per cent by 2020, and the total costs of investing via the default fund will be less than 0.2 per cent.

#### Australia

Twenty years ago charges under the Australian superannuation guarantee pension schemes were as high as 1–2 per cent. Following the introduction of compulsory superannuation, charges have fallen, especially for large industry and public sector funds, where typical charges are now 0.5–1 per cent.

#### Conclusion

While these schemes are not directly comparable with personal accounts, they do show that costs in large-scale pension schemes can be driven down over time. International evidence suggests that a long-term target of 0.3 per cent is realistic.

## Financing personal accounts

---

- 4.9 In the short term, until revenue from scheme members' contributions comes through to cover operational costs, there will be a need to provide finance for the set up of personal accounts. There are a number of sources from which finance can be obtained. These could include the Government, suppliers such as pension providers or administrators, third parties such as banks, and members through charges. In assessing the best source of finance for the set up and operation costs, the following criteria will be considered:
- low charges for members;
  - value for money for taxpayers;
  - European Union public procurement rules and legislation on competition; and
  - commercial viability.

## Membership charge structures

---

- 4.10 Regardless of the source of funding, the majority of the costs of personal accounts will be recovered via charges on the members of the scheme. There are a number of ways in which charges can be levied on personal accounts and we have received suggestions for alternatives to the AMC structure described in the Pensions Commission report and the May 2006 White Paper.
- 4.11 Ideally, an appropriate charge structure for personal accounts would have the following attributes:
- simple and easy to understand (for example, easily comparable to other pension products in the market);
  - fair to all members, taking into account an individual's ability to pay;
  - incentivises the scheme operator to maximise the fund value;
  - incentivises members to help keep costs down; and
  - provides significant revenue in the early years of operation, thus reducing the amount and length of operating losses, and reducing financing costs.

- 4.12 Initial analysis suggests that no one charge structure, or a combination of charge structures, has all of the above attributes. Each charge structure has advantages and disadvantages and there are trade-offs that have to be made. Some potential charge structures are outlined below:
- **Annual management charge:** A charge made annually as a proportion of an individual's funds under management.
  - **Contribution charge:** A proportion of each contribution made by the member.
  - **Joining charge:** A one-off payment made by a member on entry to the scheme. One approach could be to make a charge equivalent to a month's premium, spread over an initial period (for example, the first year).
  - **Flat fee:** Charged on a regular basis and continues as long as an individual is a member of the scheme. It is not based on the size of the member's contributions.
- 4.13 The Government is determined that charges will be fair, especially for lower earners. Within that framework the Government is interested in views on the appropriate method of charging members for personal accounts, taking into account the ideal attributes set out in paragraph 4.11:
- Which overall charge structure is most appropriate?
  - How much flexibility should the personal accounts delivery authority or the personal accounts board have in deciding the charging structure?
  - Are there particular circumstances or activities for which it is appropriate to make an additional charge?

## Conclusion

---

- 4.14 The work the Government has done indicates that, despite significant uncertainties, it may be possible to achieve an AMC at a rate as low as 0.5 per cent of funds invested in the short term, and below 0.3 per cent in the long term. The Government will give the personal accounts board a duty to deliver low costs to its members. The Government is confident that charges in the scheme can be radically lower than those currently offered to the majority of our target group.

## Questions for consultation

---

The Government is interested in views on the appropriate method of charging members for personal accounts, taking into account the ideal attributes set out in paragraph 4.11:

- Which overall charge structure is most appropriate?
- How much flexibility should the delivery authority or the personal accounts board have in deciding the charging structure?
- Are there particular circumstances or activities for which it is appropriate to make an additional charge?



## Chapter 5: Investment and accessing savings





## Chapter 5: Investment and accessing savings

Investment is one of the key considerations for any pension scheme.

Personal accounts will offer a default fund to which members will be enrolled if they do not exercise choice.

The executive delivery authority will design the investment strategy within a general framework set by the Government.

Our research shows that people find pension decisions difficult and many want a simple choice, but a significant minority want extra fund choice. Personal accounts will offer a wider choice of funds and we expect this will include a choice of social, environmental and ethical funds and branded funds. It will be for the executive delivery authority and the personal accounts board to decide when and how these additional funds should be introduced.

Accessing pension saving is also critical to the scheme. Personal accounts will work within the current tax framework for pensions: most will annuitise. Individuals can find decisions about retirement income difficult, so the personal accounts board will be asked to look at how best to support individuals in making good decisions for them. One possibility is through a more structured choice process.

“Participants certainly should have a choice, but that should be achieved by offering a range of investment products for those that wish to make their own investment decisions and a default fund for those (almost certainly an overwhelming majority) who are unable or unwilling to do so.”  
(JP Morgan)

## What level of choice will be offered in personal accounts?

---

- 5.1 A simple scheme requires that fund choice is limited. Whilst accepting that some individuals would want choice, many respondents in focus group discussions felt that having a choice of funds in personal accounts would make the scheme more complicated and confusing than it needs to be, and they suggested that this is likely to increase opt-out rates.<sup>1</sup>
- 5.2 Many people are poorly equipped to make financial choices, particularly those who are younger or have lower incomes. A recent nationally representative UK survey found that many people do not shop around for financial products and one in five make choices without seeking any information or advice first. The majority (79 per cent) use only marketing information and non-independent advice when choosing financial products, and almost half do not consider either price or product features when making a decision. The survey showed that some people end up buying inappropriate or unnecessary products as a result, or do not understand the nature of the products they have.<sup>2</sup>
- 5.3 Evidence from Sweden and the USA suggests that people are particularly poorly equipped to make choices about investment asset allocation. Many adopt a naïve diversification strategy<sup>3</sup>; some heavily base their decisions on funds' previous returns; and others concentrate their assets in their own employer's shares, mistakenly viewing them as safer.<sup>4,5</sup>

<sup>1</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>2</sup> Atkinson A, McKay S, Kempson E and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, Financial Services Authority Consumer Research Report No 47.

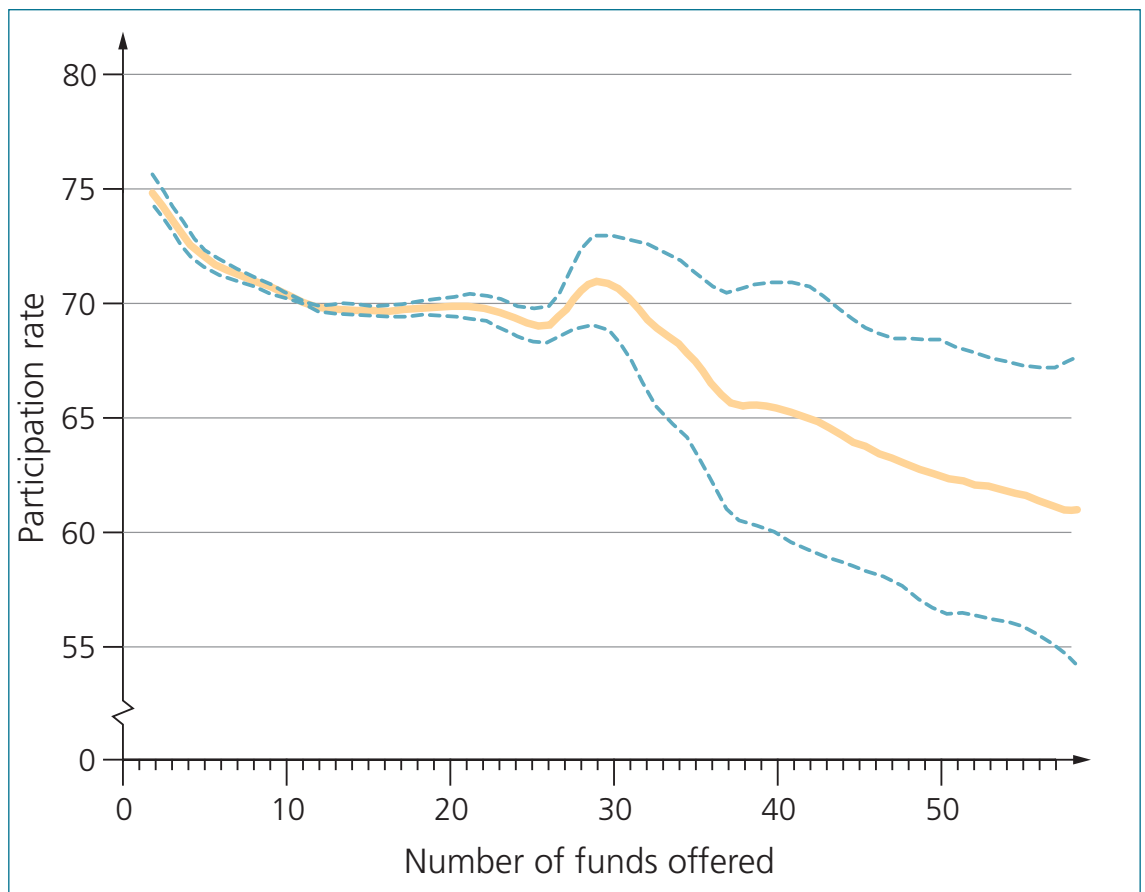
<sup>3</sup> In which money is divided equally among a number of funds, irrespective of the underlying asset composition of the funds.

<sup>4</sup> Benartzi and Thaler, 2001, *Naive diversification strategies in defined contribution saving plans*, *The American Economic Review*, 91(1): 79–98.

<sup>5</sup> Mitchell and Utkus, 2002, *Company stock and retirement plan diversification*, Pension Research Council Working Paper.

- 5.4 Evidence from the US 401(k) schemes shows that participation rates fell as the number of fund options increased; participation rates were particularly low when fund options exceeded 30.<sup>6</sup> (Figure 5.1).

**Figure 5.1: The relation between the number of funds offered and participation in 401(k) pension schemes**



Source: Figure taken from *How much choice is too much?: Contributions to 401(k) retirement plans*, by Iyengar, Jiang & Huberman, 2003. PRC paper in 2003. Reproduced by permission of the authors.

Note: The graph was plotted using a two-stage parametric estimation method and so is by no means certain. The dotted lines show 95 per cent confidence intervals.

<sup>6</sup> For example, participation rates are 75 per cent for schemes with two funds, falling to just under 70 per cent in schemes with 12 funds. Participation rates drop to just over 60 per cent in schemes with over 50 funds.

- 5.5 However, some choice is important to meet the needs of the target group. Research findings indicate that some consumers in the target group for personal accounts do want choice, particularly those with higher incomes. Some younger respondents also mentioned a desire to have the choice to invest ethically.<sup>7</sup> An appropriate level of choice helps individuals to take personal responsibility for saving for their retirement and may encourage some people to save more. A study of US 401(k) schemes showed that people with a choice of investments contributed 8.5 per cent more into the scheme than those with no choice at all.<sup>8</sup>
- 5.6 **Personal accounts will offer a structured choice of investments for members.** The board of the personal accounts scheme will have a duty to members to provide fund choices that are appropriate and serve the needs of members.
- 5.7 There will be a three-tiered approach to fund choice:
- a default fund for members who do not wish to exercise a choice;
  - a small number of bulk-bought funds at low charges; and
  - a wider range of funds, which we expect to include social, environmental and ethical investments, and branded funds.

### Box 5a: Social, Environmental and Ethical Investment (SEE) in personal accounts

SEE represents a small but growing proportion of total UK investment, current UK ethical funds constitute 1.8 per cent of total UK retail funds.<sup>9</sup>

SEE varies both by the ethical basis, for example religious or environmental, and the investment technique, for example screening-out companies or encouraging companies to change their behaviour. This investment choice comes at an additional cost because investors have to pay for active investment managers who are required to spend time ensuring investments are, and remain, ethical. It would, therefore, not be appropriate to enforce those extra charges on personal accounts members who had not actively chosen to incur them.

<sup>7</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>8</sup> Papke L, 2004, *Choice and other determinants of employee contributions to defined contribution plans*, Centre for Retirement Research Working Paper.

<sup>9</sup> Ethical Investment Research Services and Investment Management Association data.

Evidence shows that, on average, SEE has performed slightly less well than standard investment over the last ten years, though there is a great deal of variation across all types of investment.

The Government is clear that politicians should not interfere with the investment decisions or priorities in personal accounts. Instead, the Government will task the personal accounts delivery authority with choosing investments in line with members' interests. Research<sup>10</sup> suggests that some people, particularly younger people, want access to SEE. Given the apparent consumer demand, the Government envisages that personal accounts will include appropriate SEE choices. It will be for the delivery authority to decide how these should be delivered and, in particular, whether they should be bulk-bought or part of the branded choice.

Since it is anticipated that 6–10 million people will pay around £8 billion a year into personal accounts, the inclusion of SEE could represent a large boost to the relatively small but growing SEE market. The UK SEE market has total assets under management of £20.6 billion on a narrow definition: the broader definition expands this to £530 billion worth of total assets under management.<sup>11</sup>

As well as researching global best practice related to SEE, the Government intends to conduct research into the personal account target group's attitudes to SEE, and into best practice in SEE investment around the world.

In addition, the Department for Work and Pensions (DWP) will be involved in a working group to be created by the Department for Environment, Food and Rural Affairs to develop recommendations on how to remove barriers to SEE.

- 5.8 As with all defined contribution occupational pension schemes, the personal accounts governing body will have a duty to exercise prudent choice and supervision of funds offered. In order to achieve this requirement, the number of funds offered will be limited. This is in line with current trust-based occupational pension schemes.

<sup>10</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>11</sup> Eurosif SRI Study 2006, market size as at December 2005. The narrow definition covers funds which use positive screening, investing in companies with a commitment to responsible business practices, and ethical exclusion, where a large number of negative criteria and/or filters are applied. The broader definition covers use of engagement policies to encourage more responsible business practices, and more general ethical approaches to investment.

## The default fund

---

- 5.9 A default fund is common practice in existing pension schemes. The idea of a default fund was well received by participants in recent DWP research for its simplicity and straightforwardness.<sup>12</sup> The 2004 Pension Plan Design Survey<sup>13</sup> found that 64 per cent of defined contribution schemes offered a default investment fund.
- 5.10 The personal accounts default fund is essential for those individuals who do not wish to exercise choice or feel that choice is not necessary. A 2005 survey<sup>14</sup> of UK defined contribution occupational schemes by Aon Consulting found that less than a quarter of participants select funds other than the default.
- 5.11 The Government anticipates that the personal accounts default fund will have the following characteristics to ensure that individuals who do not make an active investment choice are defaulted into an appropriate investment:
- the default fund will be structured to deliver an appropriate trade-off between risk and return for the target group;
  - the default fund will be invested across many different asset classes to reduce specific investment risk; and
  - the default fund will be life-styled so that, for example, an individual's investments will be moved out of equities into bonds as they approach retirement age to ensure the timing risk related to accessing an annuity is reduced.

<sup>12</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

<sup>13</sup> Watson Wyatt, 2005, *FTSE 100 Defined Contribution Pension Scheme Survey 2005*.

<sup>14</sup> Aon Consulting, 2005, *DC Pension Provision Report*.

## Who should be responsible for different aspects of investment in personal accounts?

---

- 5.12 Developing investment strategies is not an area of Government expertise – in both the creation and running of personal accounts it is vital to have independence from both politicians and pressure groups. This will be members' money and their pension in retirement and it is vital that their savings are protected from external pressures. The Government proposes to take primary powers in the second pensions Bill to require the executive delivery authority, advised by an investment committee, to develop an appropriate investment strategy within a framework prescribed by legislation.
- 5.13 The high-level framework for investment is likely to include the following:
- facilitating the best possible risk-adjusted net rate of return through low fund-management charges;
  - specifying the provision of a default fund; and
  - regularly reviewing the suitability of the investment funds and fund managers chosen for personal accounts.
- 5.14 The Government intends to task the executive delivery authority with establishing an investment management committee that will:
- consist of people with appropriate knowledge and skills;
  - be independent of, and operate at arm's length, from Government;
  - be responsible for development of a clear investment strategy; and
  - provide advice for the recruitment of investment managers.
- 5.15 Whilst it is appropriate for the Government to set out the principles of investment, it is essential for the executive delivery authority to have the scope to implement the investment principles in a manner that it considers most suitable, and to have the flexibility to make adjustments and decisions which take into account future changes in the pensions environment.

- 5.16 The executive delivery authority will have a duty to provide a range of choice but they will also have responsibility for deciding how and when. In particular, the delivery authority will need to balance the demand for extra choice from the minority with the demand for simplicity from the majority, in the way the choice is structured, and ensure charges are fair between groups.

## Accessing pension savings (decumulation)

---

- 5.17 The private pension reforms proposed in the May 2006 White Paper will add millions more pension savers to the market, who will be required to secure an income at some point for their retirement. As the White Paper emphasised, personal accounts will be subject to the same decumulation rules as other pension schemes:
- pension income cannot be accessed before the age of 55 and income must be secured by the age of 75;
  - up to 25 per cent of a pension fund can be taken as a tax-free lump sum;
  - individuals who have accumulated small pension funds are not required to secure a pension income and can take their pension as a taxable lump sum; and
  - if an individual dies before reaching age 75 without accessing their savings, a further pension or lump sum will be payable to their dependants.
- 5.18 While personal accounts will be subject to these same tax rules, it is necessary to examine the process by which individuals will access their savings in retirement. The delivery authority will be responsible for developing these detailed processes.
- 5.19 This work will be based on by the review of the “open-market option” (OMO), whereby individuals can shop around for their annuity to get the best deal rather than purchase from the provider they made their savings with. The review was announced by HM Treasury in its paper on annuities published at pre-budget report 2006, and will involve HM Treasury and DWP working together with a range of stakeholders to improve the operation of the OMO for consumers.<sup>15</sup> The review will explore whether measures of success, such as an increase in the percentage of consumers exercising the OMO, should be set and look at the ways in which individuals are currently informed about the options of particular annuities, and whether changes should be made. In addition, it will look at the role of joint life annuities following the abolition of contracting out for defined contribution schemes.

<sup>15</sup> *The Annuities Market*, HM Treasury, PBR 2006.



- 5.20 It will also examine the potential for a more structured approach to annuity purchase that could be applied to the personal accounts scheme. This process could involve a two-staged approach. At the first stage, the individual would decide the type of annuity most suited to their circumstances, supported by suitable information and guidance. This could include information which highlights the consequences of choosing a single life annuity if the individual has a partner. At the second stage, the individual would select a provider offering the best deal on this product, perhaps with the aid of, for example, the Financial Services Authority's comparative tables or an annuity purchase platform.
- 5.21 For those who do not make an annuity decision by the age of 75, it will be necessary for annuities to be purchased on behalf of individuals. The decision on the default annuity at age 75 for personal accounts is an area the executive delivery authority is better placed to consider.
- 5.22 The Government has considered the option of bulk purchasing annuities for personal accounts participants. This would involve the negotiation of a batch of annuities to cover either everyone, or a specific sub-group wanting to annuitise during a given time period. Individuals who may benefit from this might include those with small pots where the administration costs are equivalent to a significant proportion of the pot.
- 5.23 However, after considering the main drivers of cost – namely life expectancy, administration costs, the annuity providers' attitude to risk and their profit margin – the Government has found no evidence that bulk purchasing of annuities could lead to a significant increase in value for members. Additionally, requiring the delivery authority or clearing house to bulk purchase annuities could increase its costs, by adding a requirement to negotiate regularly and find suitable deals.

## Conclusion

---

- 5.24 Personal accounts will offer a default fund, into which members will be enrolled if they do not exercise choice, and a wider choice of funds. Investment design will be undertaken by the delivery authority through exercise of its expertise in the investment field.
- 5.25 The decumulation rules for personal accounts will be the same as for other pension provision. The detailed design of the process will be a matter for the delivery authority. The design of the process will be based on the conclusions of the review of the OMO's operation.





## Chapter 6:

# Employers and private pension reform



## Chapter 6: Employers and private pension reform

Employers are at the heart of the pension reform programme. Many employers already offer good pension provision for their employees. The Government aims to maintain this existing provision.

For those employers who are not already offering pension provision, the Government is keen to ensure that personal accounts present the minimum of additional burdens.

The Government is proposing simple exemptions from the requirements of personal accounts to help support existing provision. The tests will be based on tests already used for other purposes, and where possible will be self-certifying.

The Government is consulting on how it can phase in exemption to help employers manage costs and on whether more generous schemes should be able to operate a waiting period.

The compliance regime will be light-touch and designed to support employers in their new obligations. It will be based around a three-part strategy – education, enabling and enforcing.

- 6.1 The proposed reforms set out in the May 2006 White Paper to both the state and private pension systems were welcomed by employers' representatives as necessary measures to guard against future pensioner poverty and promote private saving. In particular, employers recognised the long-term economic benefits of addressing the issue now, rather than waiting until the problems became acute. They also recognised that increased private pension wealth will benefit the economy as a whole.
- 6.2 Public reactions to the proposals and research Government has done with employers demonstrate broad support for the Government's package of reforms:  
  
"Members have welcomed the proposal to introduce a new system of low-cost personal accounts."  
**(Confederation of British Industry)**  
  
"EEF supports auto-enrolment into the new pensions savings scheme."  
**(Engineering Employers' Federation – The manufacturers' organisation)**

- 6.3 Department for Work and Pensions (DWP) research shows that a majority of people<sup>1</sup>, some 72 per cent, agreed with the proposals that employees should be automatically enrolled into personal accounts with the choice to opt out.<sup>2</sup> Further research with employers found 59 per cent of organisations with less than 50 employees thought that automatic enrolment was a good idea, rising to 81 per cent of employers with 250 or more employees.<sup>3</sup>
- 6.4 The Government's reform programme continues to place employers at the heart of pension provision, and can only be successful with the support and involvement of employers. Many employers in the UK are already making substantial contributions to pension schemes and are supporting their employees in saving for their retirement. The Government wants to continue to support employers who are already making these contributions. But to make the package of reforms successful the Government needs all employers to play their part.
- 6.5 Minimising the burdens on employers has been a guiding principle throughout the development of the reforms. This central objective has led us to a series of proposals:
- the level of the minimum employer contribution will be set in legislation to remove uncertainty as to future increases;
  - the minimum employer contribution will be phased in over three years;
  - one of the key criteria for deciding the delivery model was the impact of relative burdens imposed on employers;
  - the tests by which existing employer pension schemes will gain exemption from personal accounts will be as simple and straightforward as possible;
  - the personal accounts scheme will be designed to focus on the target market, and not to compete with existing employer schemes: the personal accounts board will have a specific duty covering this; and
  - the compliance regime will be light-touch but effective.

<sup>1</sup> Participants were recruited to reflect the United Kingdom population in relation to a series of key demographic and other variables.

<sup>2</sup> Opinion Leader Research, 2006, *National Pensions Debate Final Report*, research carried out for DWP.

<sup>3</sup> Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*, DWP Research Report No 397.

- 6.6 Chapter 2 provides details of the model chosen to deliver personal accounts. Minimising the burden on employers was a key criterion. Analysis shows the National Pension Savings Scheme (NPSS) approach meets that test. In particular, government research and consultation with employers identified that those employers who do not currently offer work-based pension saving do not feel equipped to make decisions on their employees' behalf. In selecting the delivery model, the Government has ensured that these employers will not be exposed to this burden. Employers will have to decide whether to offer a personal account and/or their exempt scheme.

Over the summer of 2006, we conducted several in-depth consultation exercises with employers and their representative bodies, to help the Government analyse how the reforms could be designed to both promote existing workplace schemes and minimise any additional employer requirements. The Government is committed to minimising the burdens on employers and simplifying the process for them.

A key part of this consultation was a series of seminars held with employers and their representative bodies, including specific events on:

- the impact of personal accounts on all employers;
- employer scheme exemption from personal accounts; and
- the impact of personal accounts on small employers.

These events helped Government to understand the concerns of employers, and the contributions made at those seminars – and in the many other informal meetings – have been invaluable in developing our proposals for reform.

## The exemption process for pension schemes

---

- 6.7 The Government wants to support existing provision. To achieve this the Government will allow those employers that offer pension schemes which are equivalent to, or provide more generous benefits than, personal accounts to automatically enrol their employees into those schemes rather than personal accounts. These types of scheme are offered by 15 per cent of employers and provide pensions for 23 per cent of all employees.<sup>4</sup>
- 6.8 The Government has used two key guiding principles in developing the exemption tests:
- **Simplicity** – any exemption test should be as straightforward as possible for employers, promoting understanding and avoiding unnecessary burdens.
  - **Participation** – we want to ensure that our proposals maximise the number of employees with good pension coverage.

## Simple tests

---

- 6.9 The Government does not want to place unnecessary burdens on employers who already provide high-quality pension schemes for their employees. Employers should therefore be able to seek exemption through self-certification, based on a small number of clear criteria.
- 6.10 The diversity of employer provision reflects the choices that employers have made about how they want to support their employees' pension savings and reflects the needs of their businesses. The Government has developed tests that reflect and support that diversity. We are proposing tests for occupational defined benefit and defined contribution schemes and consulting on how these tests can be adapted for employers who have chosen to provide hybrid schemes or personal pensions.
- 6.11 The basic principle underlying the exemption proposals is that employer contributions and benefits for exempt schemes should be broadly equivalent to those for personal accounts. The earnings bands on which contributions are paid would also need to be the same to ensure parity for individuals.

<sup>4</sup> Source: *DWP modelling of Employer Pension provision 2005* and *Small and Medium-sized Enterprise (SME) Statistics 2005*. Proportion of employers that offer a pension contribution of 3 per cent to at least some of their employees. Number of employees in a pension scheme with a 3 per cent or more employer contribution as a proportion of total employees.



- 6.12 The Government also considered whether additional benefits associated with a pension scheme, such as death-in-service benefits, ought to be taken into account as part of the exemption test. This would involve additional complexity so it is not proposed to include them in the test.

## Exemption for occupational defined benefit schemes

---

- 6.13 Defined benefit schemes based on final or average salary remain an important and significant part of employer provision.
- 6.14 The eventual level of benefits that savers receive through defined benefit schemes does not necessarily relate to the level of contributions from employers and employees. This means a simple comparison of contribution levels would not be a fair test of parity between a defined benefit scheme and personal accounts. **The Government has decided that the exemption test for a defined benefit scheme should be based on the rate of benefit accrual.** There are two types of defined benefit schemes – contracted-in and contracted-out. These need to be considered separately.

## Contracted-out defined benefit schemes

- 6.15 Around 95 per cent of active members in defined benefit schemes<sup>5</sup> are in a scheme that is contracted out of the State Second Pension. As a result their scheme has already been subject to a test – the Reference Scheme Test.<sup>6</sup> There are about 6,000 private sector contracted-out defined benefit schemes with around 3 million scheme members.<sup>7</sup>

<sup>5</sup> Government Actuary's Department, *Occupational Pensions Scheme Survey 2005*. Based on schemes with 12 or more members.

<sup>6</sup> The Reference Scheme Test is a test of overall pension scheme quality currently used for defined benefit pension schemes that are contracted out of the State Second Pension. A scheme satisfies the test if the pensions provided to at least 90 per cent of the members are broadly equivalent to, or better than, the pension which would be provided under the Reference Scheme which: is payable from age 65; is paid for life; accrues for each year of pensionable service (maximum 40 years) at the rate of 1/80<sup>th</sup> of average qualifying earnings in the last three years of service; is based on qualifying earnings defined as 90 per cent of earnings between the Lower Earnings Limit and Upper Earnings Limit; and provides for a 50 per cent survivor benefit for a spouse or civil partner.

<sup>7</sup> Source: Government Actuary's Department, *Occupational Pensions Scheme Survey 2005*. Based on schemes with 12 or more members.

- 6.16 Schemes that satisfy the Reference Scheme Test typically offer accruals at a rate of 1/80<sup>th</sup> of pensionable earnings each year and are recognised as high-quality schemes. The Government therefore sees no value in setting an additional test for these schemes and **we propose to use the Reference Scheme Test with automatic enrolment as the exemption test for contracted-out defined benefit schemes**. This should simplify processes for the people managing employer schemes.

### Contracted-in defined benefit schemes

- 6.17 For contracted-in defined benefit schemes – which are not subject to the Reference Scheme Test – the Government has focused instead on finding a level of accruals, supported by analysis from the Government Actuary's Department, that provides a comparison with what individuals could expect to achieve from personal accounts.
- 6.18 The Government concluded that **contracted-in defined benefit schemes should provide automatic enrolment and accrual rates of at least 1/120<sup>th</sup> of pensionable earnings for each year of service to gain exemption from personal accounts**. Analysis from the Government Actuary's Department suggests that a 1/120<sup>th</sup> accrual broadly equates to an 8 per cent contribution into a personal account throughout the working life of a median earner.

### Exemption for occupational defined contribution schemes

---

- 6.19 Defined contribution occupational schemes are an increasingly important element of workplace pensions. As personal accounts will be an occupational defined contribution scheme it is easier to draw direct comparisons.
- 6.20 The test should be carried out at scheme level, ie the benefits applying to the scheme in general and be based on offering **automatic enrolment** and two other criteria:
- **Contributions paid into the scheme must be at least equal to the minimum being paid into personal accounts**. This means that schemes that offer a minimum default contribution for individual scheme members of 8 per cent with a minimum of 3 per cent from the employer, should be exempt.
  - **Schemes must offer a default investment option** but will be able to offer an additional choice of funds if they want to.

- 6.21 Evidence suggests that most occupational defined contribution schemes have charges equivalent to an annual management charge (AMC) of under 0.6 per cent.<sup>8</sup> This level is broadly comparable with that anticipated for personal accounts so the Government has decided that charges should not form part of the exemption test. The Government proposes to take legislative powers to reconsider this question if charges in these schemes cease to be comparable with those offered by personal accounts.

### 'Non-occupational' workplace pension provision

- 6.22 Employer-sponsored personal pension provision, where an individual buys a contract-based personal pension and receives a contribution from their employer (including high-quality stakeholder pensions and 'Group Personal Pensions'), is a significant part of the existing market.
- 6.23 Under European law pure automatic enrolment<sup>9</sup> cannot be used with these contract-based schemes since the employee's written consent to be enrolled is required. But the Government does not want this to be an obstacle to exemption. The guidance on automatic enrolment issued last year for workplace personal pensions outlines a modified type of automatic enrolment which could be used.
- 6.24 **The Government would like to continue to support these arrangements without disadvantaging employees, and is interested in views on:**
- How can the Government treat such 'non-occupational' workplace pension arrangements as 'schemes' for the purposes of exemption from personal accounts requirements?
  - How can the Government ensure that, in the absence of automatic enrolment, these vehicles can offer similar levels of coverage and saving to those estimated for automatic enrolment?

<sup>8</sup> Government Actuary's Department, 1998, *Survey of expenses of occupational pension schemes*.

<sup>9</sup> Where the written consent of the employee is not required for enrolment into the scheme.

## Waiting periods

---

- 6.25 The May 2006 White Paper stated that the objective of introducing automatic enrolment and personal accounts was for all employees to have access to pension saving from the start of employment. A number of responses to the White Paper argued that there should be a waiting period of six months or even a year. However, waiting periods would disadvantage employees who change jobs often, or do seasonal work, as it could mean they lose the opportunity to save for significant periods.
- 6.26 The Government welcomes views on this point but there is strong evidence against requiring any waiting period:
- only a minority of workplace schemes, namely 16 per cent, currently operate a waiting period;<sup>10</sup>
  - of these workplace schemes, around 80 per cent have a waiting period of at least a year, representing around 320,000 members<sup>11</sup>; and
  - the impact of a six-month waiting period on the final pension savings for a median earner (£23,000 a year) who saves for 43 years – assuming a 3 per cent employer contribution and an AMC of 0.5 per cent – would lead to their final pension savings being reduced by approximately 9 per cent if they had, on average, eight job moves over their lifetime.<sup>12</sup> Those who move more often would face even more of a reduction in their final pension savings if a waiting period were allowed.
- 6.27 **The Government is not proposing a formal waiting period in personal accounts**, although it recognises there will be a short period before the automatic enrolment process is completed. **This is an area on which the Government continues to welcome views.**

<sup>10</sup> Source: supplementary analysis of data from the Government Actuary's Department's *Occupational Pension Schemes 2004* – 16 per cent of open schemes (weighted by active members) with more than 12 members that responded to the question stated that the scheme operated a waiting period.

<sup>11</sup> Source: supplementary analysis of data from the Government Actuary's Department's *Occupational Pension Schemes 2004* – 16 per cent of open schemes (weighted by active members) with more than 12 members that responded to the question stated that the scheme operated a waiting period.

<sup>12</sup> Over a 40–45 year working life, individuals, on average, change jobs around 7–8 times: *Labour Force Survey*, 2006 DWP analysis. Notes: Assuming a 3 per cent employer contribution. Job moves are spread evenly over the lifetime. These figures do not include contracted-out since in 2012 contracting out will not be possible. Monetary values are quoted in 2006/07 earning terms.

## Waiting periods for exempt schemes

---

- 6.28 If employers operating their own schemes with a waiting period want to continue with these schemes rather than operate personal accounts, the initial assumption was that they would automatically enrol their staff into a personal account in the intervening period. During the course of consultation, some stakeholders argued that the Government should relax this requirement, particularly for employers who make contributions above the minimum for personal accounts.
- 6.29 The current estimate is that there are approximately 160,000 employers with 5.7 million members who offer an employer contribution of at least 6 per cent.<sup>13</sup> The Government estimates that around 3.8 million individuals – aged between 22 and 64 – begin working for a new employer every year. Of these, some 1.2 million work for an employer offering a contribution of greater than 6 per cent.
- 6.30 Allowing a waiting period would mean that employers with high-quality exempt schemes would not have to automatically enrol employees immediately into personal accounts and would benefit in terms of reduced contribution and administration costs. However, this could affect individual outcomes as it excludes members of the Government's target group such as those with regular job changes, and casual and seasonal workers.
- 6.31 **The Government is interested in views on:**
- Whether employers with exempt schemes, and contributions above the personal accounts minimum, could operate a short waiting period, of perhaps three or six months, to encourage them to continue to offer high-quality schemes.
  - What should be the minimum level of contributions above which a waiting period is acceptable.

<sup>13</sup> Number of individuals and contribution cost estimates based on DWP's analysis of *Employers' Pension Provision Survey 2005*, *Small and Medium-sized Enterprise (SME) Statistics 2005*, *Annual Survey of Hours and Earnings 2005* and *Labour Force Survey 2006*.

### NAPF quality mark proposal

The National Association of Pension Funds (NAPF) has suggested that employers running high-quality schemes should be given greater flexibility than those employers who are contributing at, or just above, the minimum: they should be allowed to have a six-month waiting period before they are required to automatically enrol.

NAPF has proposed a 'Good Workplace Pension' quality mark which is designed to raise the profile of schemes and be something that employees can easily recognise as a scheme that offers high-quality pensions. They propose that accreditation should function in a simple light-touch way.

Under this proposal, the quality mark would be awarded to employers' schemes with total, and employer, contributions higher than personal accounts. All scheme members would be provided with information about the quality mark, thereby helping them better understand the value of the pension on offer.

The Government supports this proposal and is keen to see it happen, although it is the responsibility of the pensions industry to develop further details and ultimately establish a quality mark. However, the Government will consult on flexibility around waiting periods for high-quality exempt schemes.

## Automatic re-enrolment for exempt schemes

---

- 6.32 Chapter 1 sets out the principle of re-enrolment. Within the personal accounts scheme the Government intends to re-enrol employees who have previously opted out every three years in recognition of the fact that people's circumstances change and they may now wish to save.
- 6.33 The Government has also considered re-enrolment into exempt schemes. We recognise that re-enrolment could incur significant costs, particularly for those employers offering defined benefit schemes. In defined benefit schemes the benefit a member receives is not linked to the contributions they have paid and so, could potentially be disproportionately costly for the employer. The Government therefore needs to consider re-enrolment requirements carefully to ensure they do not threaten the long-term stability of these schemes. Equally, the Government needs to ensure that individuals have access, on an ongoing basis, to pension saving through their workplace.

## Helping employers adjust to the new arrangements

---

- 6.34 In the May 2006 White Paper the Government recognised that employers would need time to adjust to the proposed changes and would require certainty about the nature and costs of the reforms. Therefore, the Government proposed:
- setting in primary legislation the minimum level of the employer contribution; and
  - phasing in the minimum employer contribution for personal accounts over three years, starting with 1 per cent in the first year, rising to 2 per cent in the second and then to 3 per cent in the third year – with proportionate rates of employee contributions.
- 6.35 In research 63 per cent of employers said phasing in the minimum employer contribution over time would be helpful.<sup>14</sup> The Government thinks three years is a good compromise, as a longer phasing period would adversely affect the pension saving of individuals and increase the costs of running personal accounts.
- 6.36 The Government's priority is to design the scheme and the transition phase so that the burdens on employers are minimised. **As part of this work, the Government is setting up a cross-government analytical group to look at the administrative impacts of the reforms. The Government will continue to work to understand this area and how it can minimise the impact and support employers as it implements this reform.**

### Phasing-in requirements for exempt schemes and sponsoring employers

- 6.37 Where employers operate existing exempt schemes, automatic enrolment should produce higher participation rates and therefore, correspondingly higher costs for these employers. Many employers' occupational schemes are more generous than the minimum the Government is proposing for personal accounts, so these costs could be significant. **The Government proposes that these employers should have the same phasing-in period as those operating personal accounts.**
- 6.38 The Government does not believe it would be appropriate simply to set employers operating exempt schemes a deadline of 2015 to deliver this change. This could create inequalities compared with those employers operating personal accounts and their employees. The Government therefore believes that there should be a framework for the phasing although this need not be the same as the framework for personal accounts.

<sup>14</sup> Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*, DWP Research Report No 397.

- 6.39 The Government thinks there are two ways to achieve this:
- by phasing in contributions in a similar way to personal accounts; or
  - by allowing employers to phase in membership for different employees in stages, for instance beginning with new starters.
- 6.40 The Government would welcome views on how to ensure that employers with exempt schemes have the flexibility to manage the implementation of the reforms in the same way as employers who will operate personal accounts, and in particular whether the approach should be by:
- phasing in the minimum employer contribution or levels of accrual for exempt schemes over three years or an appropriate period;
  - phasing in by groups of employees; or
  - some other approach.

## A light-touch compliance regime

---

- 6.41 The May 2006 White Paper stated that the proposed new rights for an employee to be automatically enrolled into either a qualifying workplace scheme, or a personal account with access to an employer contribution, needed to be safeguarded by an effective compliance regime. At the same time the Government recognised that such a compliance regime needed to be light-touch, risk-based and proportionate, in line with best practice in regulation.
- 6.42 During the development of the proposals for personal accounts, further work has been done on how the compliance regime would work in practice.
- 6.43 Our proposals are based on the following assumptions:
- most employers will seek to comply;
  - the scheme processes will assist compliance;
  - effective support for employers will be available;
  - activity to enforce compliance should impose no, or minimal, additional burdens on those employers who are complying;



- consistent with the Macrory Review<sup>15</sup> of penalties and, in order to create a level playing field, there will be proportionate penalties for those employers who do not comply;
  - employers who do not comply should not gain a financial advantage over those who do;
  - employees who choose to save in personal accounts should not suffer detrimental treatment by their employers compared with those who opt out; and
  - the compliance regime will have full regard for the principles of good regulation as set out in the Legislative and Regulatory Reform Act, 2006.
- 6.44 The introduction of personal accounts is a large-scale undertaking where the administrative economies of scale are based on maximising take-up and therefore compliance. The primary objective will be to achieve compliance from the greatest number of employers in the shortest time and at the least possible cost to employers, employees and the Government.
- 6.45 Compliance experience indicates that employers fail to comply for one of three main reasons:
- they are unaware of the requirement;
  - they are aware of the requirement but do not know what they have to do to comply; or
  - they are aware of the requirement and know what to do, but have chosen not to comply.
- 6.46 The Government, therefore, proposes to develop a three-stage compliance regime so that the numbers of employers in the first two categories are minimised, allowing compliance activity to focus on the third category of employers who are deliberately non-compliant:
- **Educating** – in the run up to the introduction of personal accounts there will be an emphasis on raising awareness among both employers and employees about the new rights and responsibilities.

<sup>15</sup> Professor Richard B Macrory, November 2006, *Regulatory Justice: Making Sanctions Effective – Final Report*.

- **Enabling** – immediately prior to the introduction of personal accounts and in the early years following introduction, there will be an emphasis on supporting employers. There will be clear information packs to help employers register for personal accounts and to make their first payments. There will also be a comprehensive helpline service so employers have easy access to support.
- **Enforcing** – if, after awareness raising and support, employers still fail to comply, there will be a graduated approach to enforcement with escalating penalties and an appeals process.

6.47 Responses to the May 2006 White Paper suggested that enforcement should be similar to that for the National Minimum Wage. The compliance regime for the National Minimum Wage includes:

- a helpline for employee or third-party whistle-blowing;
- penalties for non-compliance;
- claims to an employment tribunal on behalf of an employee if arrears are not repaid; and
- a limited amount of risk-based investigation.

6.48 The Government agrees that this is a good model on which to build, but considers that by itself it may not deliver the degree of compliance needed to protect the new employment rights which will have a long-term effect on people's ability to build up pension rights. The Government is, therefore, considering how to maximise protection for individuals without imposing additional burdens on the majority of employers who will comply with the new requirements. This might be through the use of remote data matching<sup>16</sup> to identify possible non-compliance followed by enquiries and escalating penalties where employers remain non-compliant without appropriate explanation. Such an approach would be in line with the current thinking on better regulation and should have minimal impact on compliant employers.

6.49 The precise nature of the compliance regime, particularly the allocation of responsibilities, will depend on the final shape of the personal accounts scheme. The Government is looking at ways to incorporate compliance that enable enforcement activity to be automated, thereby reducing costs and burdens on employers.

<sup>16</sup> Remote data matching is a way of identifying possible non-compliance by comparing different sets of information held for personal accounts without the need to contact employers and to ask for further information.

- 6.50 The Government will continue to discuss with stakeholders how this outline approach might work in practice. Views on the approach to compliance would be welcome, in particular:
- How can employees, who choose to save in personal accounts, best be protected from suffering detrimental treatment by their employers compared with those that opt out?
  - What type of information and support would encourage compliance?
  - How can processes be designed to encourage compliance?
  - How could the proposed penalty regime be structured?
  - How valuable would a whistle-blowing helpline for employees be?

## Conclusion

---

- 6.51 Employers play an important role in pension provision and are central to the Government's pension reforms. The Government continues to recognise the valuable contribution they make to the pension savings of their employees. In introducing reforms, the Government wants to provide an environment where employers continue to do this either through their own provision, or through personal accounts.
- 6.52 The Government wants to help employers to adjust to the proposals. This is why the Government proposes a range of measures both to support employers' existing provision and to help them deliver personal accounts. These include:
- the minimum employer contribution for personal accounts will be phased in over three years;
  - requirements for employers' exempt schemes will be phased over three years and the Government will consult on how best to achieve this;
  - the personal accounts scheme will be designed to focus on the target market, and not to compete with existing employer schemes; and
  - the compliance regime will be light-touch, but effective.

## Questions for consultation

---

For employers offering 'non-occupational' workplace pension arrangements, the Government is seeking views on:

- How can the Government treat such arrangements as 'schemes' for the purposes of exemption from personal accounts requirements?
- How can the Government ensure that, in the absence of automatic enrolment, these can offer similar levels of coverage and saving to those estimated for automatic enrolment?

For waiting periods in personal accounts:

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

In relation to waiting periods and scheme exemption, the Government is interested in views on:

- Whether employers with exempt schemes, with contributions or benefits that are higher than the minimum level, could operate a short waiting period, of perhaps three or six months, to encourage them to continue to offer high-quality schemes.
- What the minimum level of scheme contributions above which a waiting period is acceptable.

The Government welcomes views on how to ensure that employers with exempt schemes have the flexibility to manage the implementation of these reforms in the same way as employers who will operate personal accounts, for example by:

- phasing in the minimum employer contribution or levels of accrual for exempt schemes over three years or an appropriate period;
- phasing in by groups of employees; or
- some other approach.

With regard to the approach to compliance, the Government is interested in views on:

- How can employees who choose to save in personal accounts best be protected from suffering detrimental treatment by their employers compared with those that opt out?
- What type of information and support would encourage compliance?
- How can processes be designed to encourage compliance?
- How could the proposed penalty regime be structured?
- How valuable would a whistle-blowing helpline for employees be?





## Chapter 7:

### Personal accounts and existing pension provision





## Chapter 7: Personal accounts and existing pension provision

Many people in this country save through good occupational or personal pension provision. We want personal accounts to complement this form of retirement saving, not replace it.

The exemption process for employer-sponsored schemes will help this. We also propose that transfers between personal accounts and other pension schemes are not allowed, but that this position is reviewed in 2020.

We welcome views on our proposed limit on annual contributions of at least £5,000.

We want to support saving between now and 2012, and we propose a contribution limit of £10,000 in the first year of personal accounts.

Stakeholder pensions will continue to be one of the options for pension saving but the designation requirement for employers will be removed on the introduction of personal accounts.

### Addressing the problem of undersaving

---

“We already offer benefits which are at least as good as are being proposed. I guess the risk is that pension provision will be averaged down to the new level which would disadvantage people in better quality schemes but you do have to, as an employer, provide competitive packages which will attract the right sort of people.”

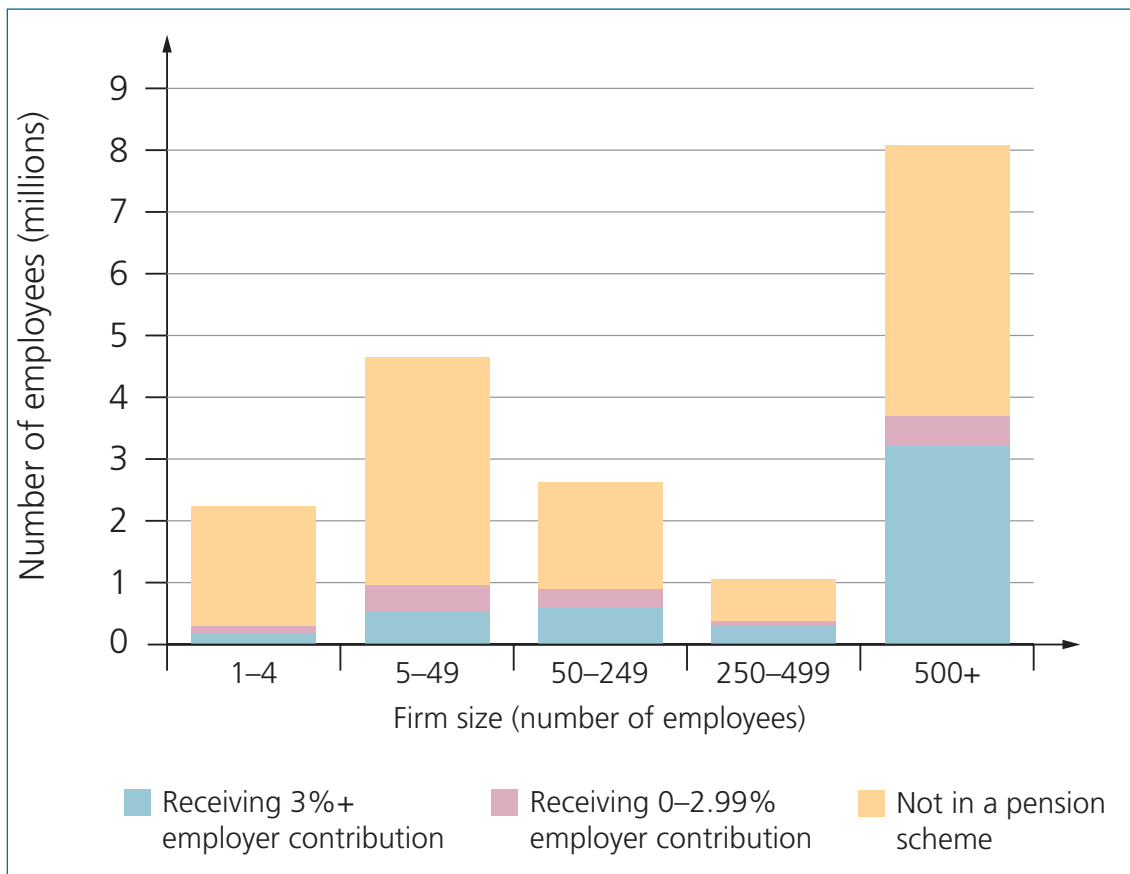
(1,000–4,999 employees, manufacturing, employer contribution)<sup>1</sup>

- 7.1 The May 2006 White Paper was launched against the backdrop of a decline in private sector employer pension provision. This trend was clearly identified in 2004 by the Pensions Commission. Factors such as increases in life expectancy and the lower equity returns since 2000 have pushed the cost of pensions higher than had been anticipated. Some of these trends have accelerated in recent years, including the reduction in the number of employees in open private sector defined benefit schemes. As defined benefit schemes have been replaced with defined contribution schemes, average contribution levels from both employers and employees have fallen.

<sup>1</sup> Marshall H and Thomas A, 2006, *Employer attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 371.

7.2 Employees working in large firms are much more likely to be in a pension scheme and to be receiving relatively generous employer contributions compared to employees working in small and medium-sized firms. There are currently around 9.5 million individuals in the UK who work for an employer who does not make a pension contribution of at least 3 per cent of the employees' salary. Of these, about 8.8 million work for an employer who offers no contributions at all.<sup>2</sup> Figure 7.1 shows the proportion of employees receiving different levels of employer contributions by firm size.

**Figure 7.1: Existing pension provision – scheme membership by firm size**



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

<sup>2</sup> Analysis based on *Employers' Pension Provision Survey 2005*, *Small and Medium-sized Enterprise (SME) Statistics 2005* and *Annual Survey of Hours and Earnings 2005*.

## Opportunities for the financial services industry

---

- 7.3 The Government's proposals for automatic enrolment, minimum employer contributions and personal accounts have been designed to address these declining trends and large areas of under-provision. The combination of automatic enrolment and personal accounts will extend the private pension market to cover those individuals hitherto excluded. From 2012, between 6 and 11 million<sup>3</sup> employees will become members of either the personal accounts scheme<sup>4</sup> or an alternative employer-sponsored scheme.
- 7.4 Pension reform presents a significant new opportunity for the financial services industry. Pension schemes and providers in the existing employer-sponsored market will see a rise in membership and contributions. The personal accounts scheme will create competition for new contracts for administration and fund management services. It is estimated that the reforms will result in an annual increase in household savings of £4–5 billion a year, and in the long term the personal accounts scheme will have between £100–200 billion in funds under management.<sup>5</sup>

## Supporting existing employer-sponsored provision

---

- 7.5 The personal accounts scheme is designed to be an addition to the already diverse market for pension products and not to replace existing employer-sponsored provision. Employers will be free to choose which type of scheme, or schemes, will be best suited to their business and employees' needs.
- 7.6 The principle of personal accounts as a complement to the existing market was overwhelmingly supported by a range of external partners in the consultation exercise conducted after the publication of the May 2006 White Paper. Employers and pension providers expressed a strong desire to maintain current good-quality pension schemes. We fully support this sentiment.

<sup>3</sup> of which we estimate that between 6 to 10 million will participate in personal accounts.

<sup>4</sup> Analysis based on *Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005* and *Annual Survey of Hours and Earnings 2005*.

<sup>5</sup> These are DWP estimates but our findings are supported by research carried out by PricewaterhouseCoopers for the DWP – Hawksworth J, 2006, *Review of research relevant to assessing the impact of the proposed National Pension Savings Scheme on household savings*, DWP Research Report No 373.

- 7.7 Many commentators have stressed the importance of ensuring that our proposed reforms result in additional saving rather than the levelling down of existing provision. It is argued that with the introduction of a minimum employer contribution of 3 per cent and mandatory automatic enrolment, employers currently offering a pension scheme may reduce access to their scheme, reduce contribution levels, or some combination of both.
- 7.8 The Department for Work and Pensions (DWP) undertook extensive research during 2006 to gain a better understanding of the impact of the Government's reform proposals on current employer-sponsored schemes. This included a nationally representative survey of over 2,500 private sector employers<sup>6</sup>, across a range of size bands, and in-depth research with 75 employers. The results showed that if employers experience additional costs as a result of pension reform, they will have several ways of managing them including increasing prices, offering lower wage increases or absorbing the increase through existing overheads. The option of reducing contributions into their pension scheme or levelling down did not emerge as a favoured approach. Of those employers who currently offered access to a pension scheme, only 1 per cent reported they were likely to reduce the level of contributions to their existing scheme, and only 2 per cent suggested they might close down or introduce eligibility restrictions for their existing scheme.<sup>7</sup> Employers with relatively generous levels of contributions said they viewed their pension scheme as an important recruitment and retention tool that they wanted to keep.<sup>8</sup>

<sup>6</sup> Interviews for this survey were carried out with the person responsible for making decisions about pension arrangements. About two-thirds (65 per cent) of those interviewed were the Managing Director or Chief Executive, owner or partner of the business, at director level, the Finance director or occupied senior positions in the Finance Department. Only 10 per cent of those interviewed occupied positions in the HR department.

<sup>7</sup> Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*, DWP Research Report No 397.

<sup>8</sup> Marshall H and Thomas A, 2006, *Employer attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 371.

- 7.9 A variety of additional surveys and studies has been carried out in addition to the research co-ordinated by DWP. Research findings can vary according to a range of factors: how many people were surveyed, who was surveyed and what questions they were asked. The additional surveys have produced a range of estimates of the potential impact of the reforms on existing provision, some indicating that the extent of levelling down will be greater than indicated by the findings described above.<sup>9</sup> We have examined these studies carefully and we will continue to work with external stakeholders to understand their findings in more detail.
- 7.10 Although the messages emerging from our own research with employers are encouraging, we recognise the degree of uncertainty surrounding all of these studies. Given this uncertainty, and the importance of promoting a vibrant market outside the personal accounts scheme, we held a series of consultation events during the summer of 2006. The purpose of these events was to stimulate debate and obtain the views of external stakeholders – including pension providers, fund managers, financial advisers, regulators, consumer groups, other government departments and academic experts – on various aspects relating to the design of the personal accounts scheme. One such proposal was the National Association of Pension Funds’ idea of awarding a ‘quality mark’ accreditation to employer schemes with contributions higher than the default level in personal accounts (see Chapter 6). Government looks forward to further discussion of this and other proposals.
- 7.11 These events were extremely useful in informing our policy development. A clear consensus emerged around the need to focus the personal accounts scheme on the target market, rather than design a scheme to compete with the successful parts of the existing market. Our stakeholders proposed several different mechanisms to achieve this, which are analysed in the next section.

<sup>9</sup> Examples of other research include:

- Chartered Institute of Personnel Development, February, 2006, *Labour Market Outlook*;
- a survey of NAPF Pension Fund Members, cited in *Quantity vs Quality? Auto-enrolment and levelling down: the evidence*, June, 2006, NAPF Research Report No 5;
- research carried out by Deloitte for AEGON, AXA, Scottish Widows and Standard Life, *Pensions Reform in the Workplace*, key findings cited in press release of 17 August 2006, *Government must act to stop reform eroding workplace pensions*; and
- Association of Consulting Actuaries, *Small Business Survey*, cited in Placard, Issue 23, April 2006.

## Targeting the personal accounts scheme effectively

---

- 7.12 The Government agrees with the emerging consensus that targeting the personal accounts scheme effectively should help to ensure that personal accounts will be a valuable addition, rather than a competitor, to existing employer-sponsored provision. We hope that successful targeting will encourage employers with current schemes to continue to provide them. The Government shares the view of the Association of British Insurers, the National Association of Pension Funds and others that one of the main objectives of private pension reform should be to increase the level of saving as well as the number of savers.
- 7.13 The previous chapters describe a series of measures designed to minimise administrative burdens on employers and promote the continuation of existing schemes. These measures include the proposal to phase in the minimum employer contribution and a simple, straightforward approach to the exemption of employer schemes from personal accounts. In addition, the May 2006 White Paper announced proposals to abolish contracting out for defined contribution schemes and allow occupational pension schemes to convert Guaranteed Minimum Pension rights into scheme benefits. We are conducting a deregulatory review of private pensions, which aims to make the regulatory framework simpler and less burdensome. We have already set out measures which, over the next three or four years, aim to deliver year-on-year reductions in administrative burdens. And we will set targets for reducing the burdens arising from requirements for businesses to provide information. We are working with key stakeholders to identify measures that will lighten regulation in this area. These proposals were developed after detailed discussions with key stakeholders and representative bodies.
- 7.14 The specific personal accounts consultation exercise over the summer looked at two further proposals for focusing the reforms on the target market: the policy on transfers to and from personal accounts; and the Pensions Commission's proposal for an annual limit on contributions.

## Personal accounts transfer policy

---

- 7.15 From 2012, between 6 and 10 million pension savers will join the personal accounts scheme<sup>10</sup>, which will be an addition to an already dynamic and diverse pensions market. Individuals will be able to continue to save in their personal accounts if they move between employers offering the scheme. However, the question of transfers between personal accounts and other schemes and products needs careful consideration. The ability of individuals to transfer pension funds to and from personal accounts could have an important influence on how the market responds to the introduction of automatic enrolment and personal accounts. **We think that there is a strong case for prohibiting transfers between personal accounts and other pension products and schemes.**
- 7.16 A prohibition on transfers between personal accounts and other schemes could help to minimise any market disturbance during the transitional period. It would remove the possibility of existing schemes moving funds into personal accounts. This measure would help to ensure that personal accounts remain focused on the target market of moderate to low earners who do not have access to good pension provision.
- 7.17 Prohibiting transfers would remove the need for employers and individuals to make complex and possibly costly decisions about pension transfers. Making a pension transfer can often involve more than just moving funds – many schemes offer a range of features that could not be easily translated into the simple, straightforward personal accounts scheme. In some cases, individuals may need to take regulated advice before making such a decision. Furthermore, if we were to allow transfers between the scheme and the rest of the market this would create additional administrative requirements.
- 7.18 The consultation exercise, conducted after the publication of the May 2006 White Paper, demonstrated support from a variety of organisations for an initial prohibition of transfers.
- 7.19 We recognise that this position should be kept under review as personal accounts evolve. **We propose that the personal accounts board should review these arrangements in 2020 to assess the market impact of the reforms and to see whether this prohibition remains appropriate.**

<sup>10</sup> Analysis based on the *Employers' Pension Provision Survey 2005, Small and Medium-sized Enterprise (SME) Statistics 2005* and *Annual Survey of Hours and Earnings 2005*.

## An annual limit on personal account contributions

- 7.20 In its second report, the Pensions Commission recommended that any new system of personal accounts should be designed as a targeted addition to the wider pensions market. To help achieve this, the Commission proposed an annual contribution limit of approximately £3,000 for a personal account. They believed that this would discourage higher-paid employees, the majority of whom already have access to pension saving, from leaving their current provision in favour of personal accounts. In our recent consultation exercises, a range of stakeholders agreed with the Commission’s proposal for a contribution limit.
- 7.21 The Government agrees that an annual limit on contributions to a personal account could be an effective way of targeting the scheme at moderate to low earners who do not have access to an alternative good scheme. However, as we want to encourage saving beyond the default contribution level, it is important that we do not overly restrict the potential for pension saving through personal accounts. In particular, we want to ensure that particular groups of individuals, such as the self-employed, and those returning from breaks from the labour market, are able to top up their accounts after any periods of non-saving.
- 7.22 We have calculated the effects of different annual contribution levels on individuals at different income levels. We have assumed that each individual is saving at the overall default rate of 8 per cent on a band of earnings between around £5,000 and £33,500 a year, and then calculated the potential for additional saving.

**Table 7.1: Effects of different contribution levels upon individuals at different income levels**

Income level	Default contribution rate (8%)	Potential additional saving given contribution limit of:		
		£3,000	£5,000	£8,000
£15,000	£800	£2,200	£4,200	£7,200
£23,000	£1,450	£1,550	£3,550	£6,550
£35,000	£2,300	£700	£2,700	£5,700



Table 7.1 illustrates that:

- for the lower earner on £15,000, reaching any of the illustrative contribution limits requires significant additional contributions;
- the median earner would be constrained by a limit of £3,000 if their total contribution is higher than the default rate of 8 per cent, for example if their employer contributes more than the minimum; and
- the higher earner would have very little opportunity to make additional contributions if a limit of £3,000 was imposed.

- 7.23 As well as suggesting a contribution limit, the Pensions Commission set benchmarks for replacement rates, with 45 per cent being the minimum and 67 per cent representing many people’s aspirations for retirement. In a defined contribution scheme, such as personal accounts, the replacement rate is dependent on investment performance. Our analysis indicates that a median earner would have to contribute up to £5,000 annually to be likely to achieve the aspirational replacement rate of 67 per cent. Chapter 5 of the Regulatory Impact Assessment provides more detail on this issue.
- 7.24 The analysis above suggests that a contribution limit of £3,000, as suggested by the Pensions Commission, would overly restrict the potential for voluntary saving. While we wish to maintain the focus of personal accounts on moderate to low earners, it is also important to allow sufficient flexibility for those individuals who wish to save more. **We therefore propose that personal accounts should have an annual contribution limit of at least £5,000 and would welcome views on whether this is the right level.**
- 7.25 We propose that the personal accounts board should be able to review the limit. In doing so, they will need to balance the two key objectives of focusing the scheme on the target market while retaining sufficient flexibility for individuals to save for their retirement.
- 7.26 We want to promote long-term saving in the period between now and the launch of personal accounts. To facilitate this, **we are proposing that in the first year of personal accounts the contribution limit is set at £10,000.** This approach will help any individual who may want to move their accumulated funds up to this limit from non-pensions savings products into personal accounts.

## Stakeholder pensions

---

- 7.27 The combination of a prohibition on transfers to and from personal accounts, and the annual limit on contributions, will help keep the scheme focused on the target market of non-savers among moderate to low earners. We also need to consider the market impact of automatic enrolment and personal accounts on the existing low-cost pension savings product – stakeholder pensions.
- 7.28 In the May 2006 White Paper, we advised that the future of stakeholder pensions would be considered carefully in the light of the introduction of personal accounts, including the current requirement placed on most employers to designate a stakeholder pension scheme for their employees.
- 7.29 We continue to see a role for stakeholder pensions in the future pensions market. Since their introduction in April 2001, stakeholder pensions have become an established pension product, with over 3 million sold at the end of June 2006. In the 2005/06 tax year, around £2.7 billion was invested in stakeholder pensions. Stakeholder pensions are a flexible and portable product, with a limit on charges and no transfer penalties, and they allow individuals to contribute intermittently, thereby enabling people with irregular income patterns to build up a pension fund.
- 7.30 We see no case for withdrawing stakeholder pensions and restricting the choice available in the pensions market. We envisage that stakeholder pensions will continue to provide a suitable option for people who may wish to supplement their other pension arrangements.
- 7.31 Looking at the stakeholder pension regulations, it is clear that, with the introduction of automatic enrolment and personal accounts imposing new obligations on employers, it would not be appropriate to retain the current stakeholder employer-designation requirements. These provisions require most employers with five or more employees to select a stakeholder pension scheme, consult their workforce about the choice, and formally designate a scheme as the one to which the company will give its workers access.
- 7.32 **We therefore plan to remove these requirements when personal accounts are introduced.** This is in line with our objective of introducing personal accounts in a way that minimises the burdens on business.

## Encouraging savings in the run-up to implementation from 2012

---

- 7.33 Setting up a new pension scheme will necessarily take time and the problem of undersaving identified by the Pensions Commission is likely to continue between now and 2012. The Government, the Financial Services Authority and the financial services industry are already leading initiatives designed to promote public awareness and understanding of personal finance. For example:
- simplifying the tax rules has made it easier for individuals to make lump sum contributions to pensions;
  - the Financial Services Authority has moved into the delivery stage of its financial capability strategy and is providing seminars on 'managing your money' in workplaces across the country; and
  - the ABI has recently announced its 'Save More Now' campaign.
- 7.34 The decision to allow contributions of up to £10,000 in the first year of personal accounts will give people the opportunity to roll-over any savings they make between now and then.
- 7.35 We plan to work with others across government, the Financial Services Authority, industry and consumer representatives to ensure that we give the public greater clarity about saving between now and 2012. This will allow us to share expertise and market knowledge, and consider how existing savings products might be used more effectively.
- 7.36 Employers – particularly those who offer occupational pensions, make contributions and use automatic enrolment – have a central role to play in encouraging individuals to save in pensions. We want to build on the relationships individuals have with their employer by encouraging employers to commence automatic enrolment into their existing schemes in the run-up to 2012. **We will continue to provide the right environment for retirement saving, and will explore, with the industry and employers, ways to facilitate saving for retirement, in the run-up to the introduction of personal accounts from 2012.**

## Conclusion

---

- 7.37 In this chapter, the Government put forward its proposals on transfers, contributions limits and stakeholder pensions, and described measures to facilitate retirement saving before the introduction of personal accounts from 2012. These measures will promote the continued existence of existing pension provision.
- 7.38 Our package of reforms will result in the expansion of private pension saving in the UK, to the benefit of the financial services industry. We will continue to monitor the impact of our reforms on existing pension saving, and continue to work with our stakeholders to achieve our common aim of promoting a diverse market for private pensions.

## Question for consultation

---

Given the twin aims of focusing the scheme on the target market and allowing sufficient flexibility for individuals within the scheme:

- Should the annual contribution limit be set higher than £5,000? If so, at what level?



Chapter 8:  
Next steps



## Chapter 8: Next steps

“The Government has worked in a collaborative way with all interested parties on the design of personal accounts. This approach needs to continue as the legislation to introduce personal accounts is developed.”  
(Association of British Insurers)

- 8.1 The introduction of automatic enrolment and the personal accounts scheme will be a significant change in how moderate to low earners save for their retirement. It will help millions of people to provide an income in their retirement that meets their expectations. This is a challenging undertaking and the Government has set a timetable for implementation to deliver against this objective. It is our aspiration that personal accounts will be introduced from 2012.
- 8.2 Much remains to be done before personal accounts can be launched, including:
- set up of a delivery authority, independent of government, with the expertise necessary to design personal accounts and source suppliers to operate them;
  - legislation to enact the personal accounts scheme and automatic enrolment; and
  - implementation of the scheme, including a communications and marketing strategy.
- 8.3 Responsibility for the implementation of personal accounts will rest with the executive delivery authority which will make arrangements for the registration of employers and enrolment of employees into personal accounts, and decide on the timetable for achieving this in a controlled manner. This will require the registration of around 1 million employers and the enrolment of around 10 million employees.

### Commercial and procurement strategies

---

- 8.4 The Government has had a very positive and constructive response to the May 2006 White Paper from a range of organisations across and beyond the pensions market. We would welcome their responses to this White Paper, along with those from other organisations who can add value to the implementation of personal accounts.

- 8.5 To meet the very challenging timetable, the Government has begun the work to produce a commercial strategy. This work will continue and be taken forward by the personal accounts delivery authority when the legal framework is in place.
- 8.6 In taking forward the commercial strategy, the Government will ensure appropriate due diligence and that a competitive procurement exercise will be conducted. We will ensure that the appropriate organisations, which can demonstrate they have the capability to deliver personal accounts, are identified to undertake these important roles.

## Legislation

---

- 8.7 The Government recently introduced legislation into Parliament to establish the advisory personal accounts delivery authority.
- 8.8 Subsequently, the Government will be seeking legislation to enable the delivery authority to take on an executive role to finalise the commercial arrangements and the infrastructure of the personal accounts scheme.

## Further research and analysis

---

- 8.9 The Government will be taking forward an analytical programme of research in support of personal accounts. The programme will improve the capacity to assess gender impacts, the welfare benefits flowing from reforms, attitudinal changes and behavioural responses. This ongoing programme will include research and analysis on:
- individual and employer attitudes towards pension reform options and their likely responses;
  - responses from the financial services industry to personal accounts;
  - the investment strategy and the optimum design elements for personal accounts;
  - the information and communication strategy needed for personal accounts; and
  - the transition to personal accounts.



## Consultation arrangements

---

- 8.10 An electronic version of this document and the accompanying Regulatory Impact Assessment are available at <http://www.dwp.gov.uk/pensionsreform>
- 8.11 The consultation is being conducted in line with the Code of Practice on Consultation. The criteria are listed below. The full version can be accessed at <http://www.cabinet-office.gov.uk/regulation/Consultation/Code.htm>. The six consultation criteria set out by the Cabinet Office are:
- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
  - Be clear about who may be affected, what questions are being asked, and the timescale for responses.
  - Ensure that your consultation is clear, concise and widely accessible.
  - Give feedback regarding the responses received and how the consultation process influenced the policy.
  - Monitor your department's effectiveness at consultation, including through the use of a designated Consultation Co-ordinator.
  - Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.
- 8.12 We will publish a summary of the comments we receive, along with a response from the Government on how we intend to proceed, within three months of the close of consultation.
- 8.13 The Government welcomes comments on all aspects of its proposals. Box 4 lists areas of particular interest.

#### Box 4: Questions for consultation

The Government is interested in views on the following areas:

1. With regard to the target group for personal accounts:
  - Whether there should be a cohort of employees approaching State Pension age at the time personal accounts are launched who should not be automatically enrolled into personal accounts.
  - Whether in practical terms, this might adversely affect the interests of this group, because they would be less likely to exercise the positive choice to opt in.
  - Whether three years is the right period for repeat automatic enrolment of employees who have opted out of personal accounts.
  - How this would affect employers and employees.
2. Delivering personal accounts:
  - How can members' interests best be represented in the governance of personal accounts?
  - What sort of information should support personal accounts and the responsibilities of different organisations in communicating this information?
3. The appropriate method of charging members for personal accounts:
  - What overall charge structure is most appropriate?
  - How much flexibility should the personal accounts delivery authority or the personal accounts board have in deciding the charging structure?
  - Are there particular circumstances or activities where it is appropriate to make an additional charge?
4. For employers offering 'non-occupational' workplace pension arrangements:
  - How can the Government treat such arrangements as 'schemes' for the purposes of exemption from personal accounts requirements?
  - How can the Government ensure that, in the absence of automatic enrolment, these can offer similar levels of coverage and saving to those estimated for automatic enrolment?

5. In relation to waiting periods in personal accounts:

- The Government is not proposing a formal waiting period for personal accounts, although it recognises that there will be a short period before the automatic enrolment process is completed. This is an area in which the Government continues to welcome views.

In relation to waiting periods and scheme exemption, the Government is interested in views on:

- Whether employers with exempt schemes with contributions that are higher than the minimum level, could operate a short waiting period, of perhaps three or six months, to encourage them to continue to offer good-quality schemes.
- What is the minimum level of scheme contributions above which a waiting period is acceptable.

6. How the Government could ensure that employers with exempt schemes have the flexibility to manage the implementation of these reforms in the same way as employers who will operate personal accounts, for example by:

- phasing in the minimum employer contribution or levels of accrual for exempt schemes over three years or an appropriate period;
- phasing in by groups of employees; or
- some other approach.

7. With regard to the approach to compliance:

- How can employees, who choose to save in personal accounts, best be protected from suffering detrimental treatment by their employers compared to those that opt out?
- What type of information and support would encourage compliance?
- How processes can be designed to encourage compliance.
- How the proposed penalty regime could be structured.
- How valuable would a whistle-blowing helpline for employees be?

8. Given the twin aims of focusing the scheme on the target market and allowing sufficient flexibility for individuals within the scheme:

- Should the annual contribution limit be set higher than £5,000? If so, at what level?

## How to respond

---

- 8.14 The consultation period began on 12 December 2006 and will run until 20 March 2007. Please ensure that your response reaches us by that date. If you would like further copies of this consultation document it can be found at [www.dwp.gov.uk/pensionsreform](http://www.dwp.gov.uk/pensionsreform). Please send consultation responses to:

Personal accounts White Paper team  
4th Floor  
The Adelphi  
1–11 John Adam Street  
London  
WC2N 6HT

Tel: 020 7712 2843  
Fax: 020 7962 8613  
e-mail: [personalaccounts-wp@dwp.gsi.gov.uk](mailto:personalaccounts-wp@dwp.gsi.gov.uk)

- 8.15 When responding, please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.
- 8.16 The information you send us may need to be passed to colleagues within the Department for Work and Pensions and published in a summary of responses received in response to this consultation along with a response from the Government.

## Confidentiality

---

- 8.17 Because of the Freedom Of Information Act (2000), all information contained in your response, including personal information, may be subject to publication or disclosure. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information which is provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this. We cannot guarantee confidentiality even if your IT system claims it automatically. The contact point to discuss is:

Charles Cushing  
Department for Work and Pensions  
Adjudication and Constitutional Issues Policy Division  
Freedom of Information and Data Protection  
2nd Floor, The Adelphi  
1–11 John Adam Street  
London  
WC2N 6HT

Tel: 020 7962 8581  
Fax: 020 7962 8725  
e-mail: [freedom-of-information-request@dwp.gsi.gov.uk](mailto:freedom-of-information-request@dwp.gsi.gov.uk)

- 8.18 More information about the Freedom of Information Act can be found on the website of the Department for Constitutional Affairs – <http://www.dca.gov.uk/foi/guidance/exguide/index.htm>.

## Feedback

---

- 8.19 DWP values feedback on how well it consults. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact the DWP Consultation Co-ordinator. In particular, please tell us if you feel that the consultation does not satisfy these criteria. Please also make any suggestions as to how the process of consultation could be improved further. Please contact

Roger Pugh  
DWP Consultation Co-ordinator  
Room 2A, Britannia House  
2 Ferensway  
Hull  
HU2 8NF

Tel: 01482 609571  
Fax: 01482 609658  
Mobile: 07887 732176

# Annex 1: Response to the House of Commons Work and Pensions Select Committee Report: recommendations and conclusions

The House of Commons Work and Pensions Select Committee published their Fourth Report, session 2005/06, on pension reform. This report included a number of recommendations and conclusions about the design and operation of personal accounts. The Government responded to these recommendations and conclusions on 30 October 2006 but the recommendations on personal accounts were not addressed in detail, as work on this White Paper continued. This annex includes more detailed responses to those conclusions and recommendations that specifically referred to personal accounts.

## Personal accounts – participation in the scheme

---

**The success of the new system of personal accounts will be critical to encouraging saving and delivering ‘adequate’ retirement incomes in the future for those on median earnings. This will need careful monitoring. (Paragraph 53)**

The Government has proposed a minimum contribution level of 8 per cent, in line with the recommendations of the Pensions Commission. This contribution level would achieve a replacement rate of pre-retirement income for a median earner, with a reasonably full working life, of about 45 per cent. This replacement rate combines income from personal accounts with the more generous State Pension provision brought about by re-establishing the link with earnings. Decisions about saving above this minimum level will be for individuals to make depending on their circumstances. This White Paper sets out how personal accounts will be delivered independently of government. The Government proposes that the remit for the personal accounts board will be to optimise contributions. As part of its governance structure, the board will submit annual reports to Parliament on its performance against its objectives.

## The decision to opt out

---

**The target group for the new system of personal accounts includes those on low to median incomes, many of whom do not currently have access to financial advice. For some people deciding to save for a pension will involve complex decisions regarding, for example, how to deal with existing financial commitments. Generic financial advice would assist people in doing this effectively. (Paragraph 64)**

Providing good-quality information will be critical to the success of personal accounts.

A number of organisations are involved in communicating information about pensions including the Department for Work and Pensions (DWP), the Financial Services Authority (FSA), the Pensions Advisory Service and a number of organisations in the voluntary sector. The Government will be working with these groups to develop an evidence-based information strategy for communicating information about pensions and personal accounts over the next year. The Government will also be paving the way for the success of personal accounts by building awareness of pensions issues through its ongoing information programme.

This work will be developed in the context of the national strategy for financial capability led by the FSA and the Government's long-term strategy on financial capability, to be published shortly. The Government's strategy will also address the issue of widening access to generic financial advice in greater detail.

## Participation rates

---

**In response to this report, the Department should outline its strategy for maximising participation in the new system of personal accounts, explain what targets it intends to set for participation in personal accounts, identify a level of participation below which it will review the policy of auto-enrolment and consider whether people should be compelled to participate, and outline contingency plans for coping with the workload if participation is higher than expected. (Paragraph 72)**

The Government will encourage participation in personal accounts through an evidence-based information strategy, highlighting, in particular, the value of the minimum employer contribution and the tax relief on contributions, and the importance of saving in a pension to ensure that individuals meet their expectations for income in retirement.



The Government will monitor and evaluate the success of automatic enrolment in meeting its overall aims and objectives. We have no plans at present to introduce compulsory membership of personal accounts, and our analysis suggests that we can build in sufficient capacity to deal with higher levels of participation, but this will be monitored throughout the implementation phases and once the system is up and running.

## Employees in small and micro businesses

---

**Small employers are more likely than large ones to offer no pension provision and there is concern among this group at the prospect of being obliged to administer and contribute to employees' pensions. The Government should outline its strategy for maximising participation among employees in small businesses. (Paragraph 79)**

Over the summer of 2006, the Government conducted several in-depth consultation exercises with employers and their representative bodies, to analyse how the reforms could be designed to both promote existing workplace schemes and minimise any additional employer requirements. Part of this consultation included a seminar on the impact of personal accounts on small employers.

The proposals for personal accounts have been designed to minimise the burden on **all** employers:

- the level of the minimum employer contribution will be set in primary legislation;
- the minimum employer contribution will be phased in over three years;
- one of the key criteria for deciding the delivery model was the relative burdens imposed on employers;
- the criteria by which existing employer pension schemes will gain exemption from personal accounts will be as simple and straightforward as possible; and
- the compliance regime will be light-touch but effective.

## The self-employed

---

**The White Paper does not provide the self-employed either with access to the State Second Pension or with an automatic enrolment process to the personal accounts system. This will make a strategy to maximise participation in personal accounts by this group critical. (Paragraph 82)**

The Government will offer self-employed people membership of the personal accounts scheme on a voluntary opt-in basis. However, there will not be a minimum contribution level because, this is not practical given the changeable cash flow situation of the self-employed. Self-employed people will, therefore, be able to save in personal accounts at a level of their choosing, subject to the proposed cap on contributions which applies to all members.

Communications to support personal accounts will be designed with the needs of the self-employed in mind.

## Additional contributions

---

**The Department should set targets for additional contributions above the minimum 8 per cent and publish a strategy to deliver, and closely monitor, progress. (Paragraph 86)**

The extent to which people save beyond the minimum contribution will depend on how much they can afford to save as well as on the replacement rate they wish to achieve in retirement. But this is only one factor that will be relevant. People will need to understand the benefits of saving more and the process of increasing contributions will need to be simple.

The personal accounts delivery authority and board will be tasked with encouraging people to increase their own contributions above the minimum 4 per cent. They will need to provide information to support people to make such decisions and ensure the processes remain as straightforward as possible.

## The implications for employers

---

We agree that the Government will need to monitor closely the impact of the new personal accounts scheme on existing occupational provision and guard against levelling down. This will need to be a key aspect of consideration in the regular reviews of the system and the further independent study that we have recommended should be instigated before the end of the next Parliament. (Paragraph 100)

The aim of personal accounts and automatic enrolment is to increase saving for retirement. However, we will continue to support existing employer pension provision. To achieve this, the Government will allow those employers that offer pension schemes which are equivalent to, or provide more generous benefits than personal accounts to automatically enrol their employees into those schemes rather than personal accounts. We support the NAPF's proposal for a quality mark, and are keen to see it happen. In addition, the Government will consult on waiting periods for high-quality exempt schemes.

The Government has proposed that the personal accounts board should review the arrangements regarding transfers and contribution caps in 2020 to assess the market impact of the reforms and to see whether this proposed prohibition remains relevant.

## Monitoring and compliance

---

The Committee welcomes the measures announced in the White Paper to support employers with the new requirements imposed on them by the personal accounts scheme. The Committee is concerned that employers should not encourage employees to opt out and recommends that the Government outline its proposed arrangements for monitoring and enforcing compliance with these requirements, the mechanisms for reporting breaches with compliance and the proposed penalty regime. (Paragraph 109)

The Government proposes to develop a three-stage compliance regime:

- **Educating** – in the run up to the introduction of personal accounts there will be an emphasis on raising awareness amongst both employers and employees about the new rights and responsibilities being created.
- **Enabling** – immediately prior to the introduction of personal accounts and in the early years after introduction, there will be an emphasis on supporting employers. The Government will produce clear employer packs to help them register for personal accounts and make their first payments. A comprehensive helpline service will be provided so employers have easy access to support.
- **Enforcing** – where, despite awareness raising and support, employers still fail to comply, the Government proposes a graduated approach with increasing penalties which uses remote data matching wherever possible. The Government also intends to provide a ‘whistle-blowing’ helpline for employees who are worried that their employers may be trying to deprive them of their new rights.

The Government will work with employers to ensure that the compliance regime is light-touch yet effective.

## How automatic enrolment will work

---

Participating in the new personal accounts scheme should be as simple as possible. We believe that employees should be opted-in within three months of beginning employment. Care will need to be taken to ensure that arrangements for auto-enrolment are workable for firms with employees on ‘non-standard’ work patterns, for example, temporary contracts or more than one job. (Paragraph 117)

The Government intends that all eligible employees will be automatically enrolled into personal accounts or an exempt employer’s scheme. The Government will ensure that the automatic enrolment process is designed to be workable with firms and employees on ‘non-standard’ work patterns.

With regard to employees being opted in within three months of beginning employment, the Government does not recommend that there should be a waiting period for personal accounts, but views on this are welcomed.

## Charges

---

The Committee agrees with the Pensions Commission that the focus should be on keeping Annual Management Charges as low as possible in order to increase retirement incomes. The Committee notes that if charges cannot be driven towards or below 0.3 per cent it would substantially erode the value of people's pensions. We believe that the option of fixed administrative fees should be considered but note that the impact of such a charging structure on those saving small amounts would have to be considered as part of that review. (Paragraph 122)

This White Paper explores different charging structures for personal accounts, and the Government will be seeking views on these structures. The remit of the personal accounts board will include achieving the lowest possible charges for members.

The National Pension Savings Scheme (NPSS) approach to delivering personal accounts has been chosen as it is the lowest cost option, allowing people to keep more of their income in retirement.

The Government has set out a list of eleven criteria against which it intends to assess the two proposed alternative delivery models. We believe that two of these are particularly important: achieving a lower level of charges and simplicity for employers and individuals. For this reason, the Committee accepts the Government's initial view that this can be achieved through the delivery model proposed by the Pensions Commission. However, we await with interest the outcome of further work to establish whether similar objectives could be achieved through a limited multiprovider model. (Paragraph 127)

The evaluation of alternative models for personal accounts identifies advantages of both the NPSS and a branded provider approach. However, for the target group the Government believes that the NPSS approach would be the most effective delivery model. This is because the NPSS approach:

- is the simplest model for individuals, as they will be faced with a carefully structured range of choices that meets their needs;
- delivers low charges – because providers do not compete directly for individuals' accounts there is less marketing expenditure and switching of accounts. Low charges will ensure larger pensions for scheme members; and
- minimises delivery risk – it is not a Government model: instead, it utilises the skills, expertise and capacity of the private sector to develop, build and deliver personal accounts.

## Investment risk

---

The Government has a responsibility for the running of the macro-economy and the regulatory framework for pensions. It does not have a responsibility for investment risk in the new system of personal accounts, but Government and regulators will have an obligation to communicate the risks and benefits clearly while still encouraging participation in the scheme. In response to this report, the Government should set out how it proposes to do this. We agree with the Pensions Commission that the default fund should be a 'lifestyle-smoothing' fund with a relatively high equity weight at early ages, and a gradual shift to bonds as people approach retirement. (Paragraph 134)

Good-quality information is critical to the success of personal accounts. The Government anticipates that DWP will continue to provide information about different types of pension saving and this will include personal accounts. The Government will be working with external stakeholders to develop an evidence-based information strategy for communicating information about pensions and personal accounts over the next year.

The delivery authority, and subsequently the personal accounts board, will make decisions regarding the investment strategy. However, with regard to the default fund, the Government anticipates it will have the following characteristics to ensure that individuals who do not make an active investment choice are defaulted into an appropriate investment:

- the default fund will be structured to deliver an appropriate trade-off between risk and return for the target group;
- the default fund will be diversified across many different asset classes to reduce specific investment risk; and
- the default fund will be life-styled, for example an individual's investments will be moved out of equities into bonds as they approach retirement, to ensure the timing risk related to accessing an annuity is reduced.

The response to the recommendation concerning governance arrangements refers to the issue of independence of investment strategy.

## Governance arrangements

---

The Committee agrees with Which? and the IMA that governance arrangements – ensuring the scheme is overseen by trustees which are independent of government and have an overriding duty of care to protect the interests of savers – will be critical to the scheme’s success. Independence will also be vital to ensure that corporate governance standards are not compromised. Political interference in investment strategy and on how the voting rights of the personal accounts scheme investments are exercised would be unacceptable. (Paragraph 137)

The Government is committed to a personal accounts scheme that is independent from Government and is run in the best interests of scheme members. The task of establishing a financial scheme of this magnitude is not for government, and that is why the Government is looking to the expertise of the private financial sector to set up and eventually to run the scheme.

The Government envisages the scheme, when running, would be run by a board of governors, which would operate in accordance with statutory duties similar to those imposed upon pension trustees by trust law and specific pension-related statutory provisions. These would include setting the strategic direction of the scheme, overall management of the scheme and the investment strategy.

The governance structure will include an investment committee, serving the board of governors, with the expertise to develop an investment strategy appropriate to the best interests of scheme members within a framework prescribed by legislation.

## Setting up the new scheme

---

The Government and Pensions Commission have rightly recognised that establishing the infrastructure for the new system of personal accounts will be a challenge. We strongly recommend that Government involvement in the development of any necessary IT system is based on a clear understanding of lessons learned from previous government IT systems failures. (Paragraph 143)

The Government agrees with the committee's recommendation that the development of any necessary IT system is based on a clear understanding of lessons learned from IT systems failures across government and the private sector. The Government recognises that it is essential to bring in appropriate private sector expertise with experience of the pensions and financial services industry at an early stage to ensure that the most effective systems to deliver personal accounts are built. The Government will ensure that best practice is applied from successful IT projects both within government and also the private sector.



## Glossary

<b>Active Fund Management</b>	Funds are managed actively by buying and selling assets to try and outperform the market. Active managers use research, forecasts and their judgement and experience in making investment decisions.
<b>Active members</b>	Current employees who are contributing (or having contributions made on their behalf) to an organisation's <b>occupational pension</b> scheme.
<b>Additional Pension (AP)</b>	The earnings-related State Pension paid in addition to the <b>basic State Pension</b> . From 1978–2002 it accrued under the <b>State Earnings-Related Pension Scheme (SERPS)</b> and from 2002 it accrues under the <b>State Second Pension (S2P)</b> scheme.
<b>Additional Voluntary Contributions (AVC)</b>	<b>Personal pension</b> contributions made by someone, who is also a member of an <b>occupational scheme</b> , as a top-up to their occupational entitlement. Additional Voluntary Contributions can be made into the occupational scheme or to a standalone product called a Free-Standing Additional Voluntary Contribution plan.
<b>Annual management charge (AMC)</b>	The charge generally applied to <b>personal pension</b> plans where the fee is levied as an annual charge on the value of the fund. This charge covers the sales, administration and fund management costs of the fund.
<b>Annuity</b>	Purchased with an individual pension fund, which has been built up in a <b>defined contribution pension scheme</b> , to provide an income that is usually payable for life. A single-life annuity pays benefits to an individual. A joint-life/survivor's annuity pays benefits to the spouse/dependent partner after death. A level annuity pays constant payments, whereas an index-linked annuity pays benefits relating to an index (for example, the <b>Retail Price Index</b> ).
<b>Asset class</b>	A specific category of assets or investments, such as equities, bonds, cash or property. Assets within the same class generally exhibit similar characteristics, such as similar risks and returns.

<b>Asset allocation</b>	The mix of <b>asset classes</b> which an investor holds.
<b>Automatic enrolment</b>	A system whereby an individual is made a member of a pension scheme unless they actively opt out of the scheme.
<b>Average earnings terms</b>	Figures have been adjusted to remove the effect of increases in average earnings over time. Thus, if something shown in average earnings terms increases, it is rising faster than average earnings, whereas if it is constant, it rises at exactly the same pace as average earnings.
<b>Basic State Pension</b>	An amount of money paid by the State to those who are entitled to it and claim it. It is available from State Pension age. In general, the amount you get depends on the number of years you, your spouse or your civil partner, have contributed to the state scheme either through paying <b>National Insurance</b> contributions, or been treated as having paid <b>National Insurance</b> contributions or been awarded credits.
<b>Behavioural economics</b>	A class of economic theories using insights from psychology to understand how individuals make economic decisions.
<b>Bond</b>	A debt investment with which the investor loans money to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate.
<b>Contracting out</b>	The system by which individuals can choose to opt out of the <b>State Second Pension</b> and use a proportion of their <b>National Insurance</b> contributions to build up a <b>funded</b> pension. There are four types of schemes from which an individual may contract out. The rules and rebate levels are different for each. These are: Contracted-out Salary-Related Scheme, Contracted-out Mixed Benefit Scheme, Contracted-out Money Purchase Scheme and approved personal pension.
<b>Decumulation</b>	The drawing down of pension assets to fund retirement. In the UK, it is permitted to access pension assets partially as a tax-free lump sum and partially as an income stream (ie <b>annuity</b> or income draw down).
<b>Default fund</b>	In <b>defined contribution pension schemes</b> , some members do not make a choice of investment fund. These members will have their contributions paid into a default fund, designated for that purpose.

<b>Defined benefit (DB) pension scheme</b>	A pension scheme where the pension is related to the member's salary or some other value fixed in advance.
<b>Defined contribution (DC) pension scheme</b>	A pension scheme where the individual receives a pension based on the contributions made and the investment return that they have produced. They are sometimes referred to as 'money purchase schemes'.
<b>Discount rate</b>	An interest rate used to reduce an amount of money at a date in the future to an equivalent value at the present date.
<b>Diversification</b>	A risk management technique that mixes a wide variety of investments within a <b>portfolio</b> . It is designed to minimise the impact of performance by any one sector, industry or <b>asset class</b> on overall <b>portfolio</b> performance.
<b>Economically inactive</b>	People who are neither employed nor unemployed, for example those who are caring for children and not doing paid work.
<b>Equity</b>	Share or any other security representing an ownership interest.
<b>Final salary scheme</b>	A <b>defined benefit pension scheme</b> that gives individuals a pension based on the number of years of pensionable service, the accrual rate and final earnings as defined by the scheme.
<b>Funded pension scheme</b>	A pension scheme where pension contributions are paid into a fund which is invested, and the pension is paid out of the accumulated funds.
<b>Gross Domestic Product (GDP)</b>	A measure of economic activity in a country, calculated by adding the total value of a country's annual output of goods and services.
<b>Guarantee Credit</b>	A <b>means-tested benefit</b> which is part of <b>Pension Credit</b> and brings pensioners' income up to a guaranteed minimum level. In 2006/07 the <b>standard minimum guarantee</b> for a single person is £114.05 a week. For a couple the level is £174.05 a week. The guaranteed minimum is higher for some groups, such as disabled people and carers, who qualify for additional amounts.

<b>Her Majesty's Revenue and Customs</b>	The new department responsible for the business of the former Inland Revenue and Her Majesty's Customs and Excise. It is the department responsible for <b>National Insurance</b> .
<b>Incapacity Benefit</b>	Benefit paid to people incapable of work who have either paid, or been credited with, sufficient <b>National Insurance</b> contributions, or who became incapable of work in their youth.
<b>Independent Financial Adviser (IFA)</b>	Someone who is authorised to provide advice and sell a wide range of financial products. They are distinguished from tied financial advisers, who can only give advice on investment products offered by a specific company.
<b>Large firm</b>	For statistical purposes, the Department of Trade and Industry usually defines a large firm as one with 250 or more employees.
<b>Life expectancy</b>	Life expectancy at a given age, $x$ , is the average number of years that a male or female aged $x$ will live thereafter, and is calculated using age- and gender-specific mortality rates at ages $x$ , $x+1$ , $x+2$ , etc.
<b>Lifestyling</b>	A method used in investment fund management where an investment fund has an asset mix determined by the level of risk and return that is appropriate for an individual investor at different stages in the lifecycle. The fund invests in higher return but higher risk assets when the individual is young and gradually moves to less risky assets (ie bonds) during the 10 to 15 years before the individual plans to retire.
<b>Longitudinal study</b>	A research study which follows a group of individuals over a period of time.
<b>Means-tested benefits</b>	State benefits where the amount paid depends on the level of income and capital, and other personal circumstances.
<b>Median</b>	The median of a distribution divides it into two halves; therefore, half the group are above the median value and half below.
<b>National Insurance (NI)</b>	The national system of benefits paid in specific situations, such as retirement, based on compulsory or voluntary contributions.

<b>Occupational pension</b>	A pension that is provided by the employer where the pension scheme takes the form of a trust arrangement and is legally separate from the employer.
<b>Passive fund management</b>	Funds are managed by making as few <b>portfolio</b> decisions as possible, in order to minimise transaction costs. One popular method is to invest in the underlying assets of an externally specified financial index to follow the performance of the index.
<b>Payback</b>	The increase in real net income per £1 of contributions made to achieve that increase.
<b>Pension accrual</b>	The build-up of pension rights. In a <b>defined benefit</b> scheme this may be based on the number of years of contributions.
<b>Pension Credit</b>	The main <b>means-tested benefit</b> for pensioners, which combines <b>Guarantee Credit</b> and <b>Savings Credit</b> .
<b>Pension Protection Fund (PPF)</b>	Established in April 2005 to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.
<b>The Pensions Commission</b>	The Pensions Commission, chaired by Lord Adair Turner, was set up in 2002 to review the UK private pension system and long-term savings. The Pensions Commission has now concluded its review and been disbanded.
<b>The Pensions Regulator</b>	The regulator of work-based pension schemes in the UK.
<b>Persistency (in relation to saving)</b>	Where someone continues to make contributions to a pension scheme over time.
<b>Personal accounts board</b>	A body created to oversee the personal accounts scheme. The board of governors will be obliged to operate in accordance with statutory duties similar to those imposed upon trustees by trust law and specific pension-related statutory provisions.

<b>Personal accounts delivery authority</b>	A time-limited Non-departmental Public Body established to design and develop the infrastructure of the personal accounts scheme through to implementation.
<b>Personal accounts earnings band (PAEB)</b>	When launched, the limits for the personal accounts earnings band will be aligned with the <b>Primary Earnings Threshold</b> and <b>Upper Earnings Limit for National Insurance</b> contributions (£5,035 and £33,540 a year respectively in 2006/07) Thereafter, the personal accounts earnings band will be updated in line with earnings.
<b>Personal pension</b>	A pension which is provided through a contract between an individual and a pension provider. The pension produced will be based on the level of contributions, investment growth and annuity rates. A personal pension can either be employer-provided (a group personal pension) or purchased individually.
<b>Portfolio</b>	The collection of assets held by an investor.
<b>Price-indexation</b>	Increasing each year in line with inflation.
<b>Primary Earnings Threshold</b>	The point at which employers and employees become liable for <b>National Insurance</b> contributions. In 2006/07, the threshold is £97 a week or £5,035 a year.
<b>Rate of return</b>	The gain or loss of an investment over a specified period, expressed as a percentage increase over the initial investment cost. Gains on investments are considered to be any income received from the asset, plus realised capital gains.
<b>Real terms</b>	Figures that have been adjusted to remove the effect of increases in prices over time (inflation), usually measured by the <b>Retail Price Index</b> . Thus, if something shown in real terms increases, then it is rising faster than prices, whereas if it is constant, it rises at exactly the same rate as prices.

<b>Reference Scheme Test (RST)</b>	A test of overall pension scheme quality currently used for <b>defined benefit schemes</b> that are contracted-out of the <b>State Second Pension</b> . A scheme satisfies the test if the pensions provided to at least 90 per cent of the members are broadly equivalent to, or better than, the pension which would be provided under the Reference Scheme which: is payable from age 65; is paid for life; accrues for each year of pensionable service (40 years maximum) at the rate of one-eightieth of average qualifying earnings in the last three years of service; is based on qualifying earnings defined as 90 per cent of earnings between the Lower Earnings Limit and the Upper Earnings Limit; and provides a 50 per cent survivor benefit for a spouse or civil partner.
<b>Replacement rate</b>	Measures income in retirement as a percentage of income before retirement.
<b>Retail Price Index (RPI)</b>	An average measure of the change in the prices of goods and services bought for consumption by the vast majority of households in the UK.
<b>Risk profile</b>	The distribution of risk preferences across the target group. The risk profile shows the average, median and the extreme risk preferences that exist within the target group. This is useful in both designing the default fund and deciding the appropriate fund choices in accordance with the risk appetite of the target group.
<b>Savings Credit</b>	Part of <b>Pension Credit</b> . It is a <b>means-tested benefit</b> for people aged 65 or over, which accrues at the rate of 60p for each pound of income above a threshold (currently the equivalent of the full <b>basic State Pension</b> ) up to a maximum amount (£17.88 for a single person, £23.58 for a couple in 2006/07).
<b>Small and medium sized enterprise (SME)</b>	For statistical purposes, the Department of Trade and Industry usually defines a small and medium sized enterprise as a firm with 249 or fewer employees.
<b>Small firm</b>	For statistical purposes, the Department of Trade and Industry usually defines a small firm as one with 49 or fewer employees.
<b>Socio-economic group</b>	A classification aimed at bringing together people with similar social and economic status. The classification is based on occupation, employment status and size of employer.

<b>Stakeholder pension</b>	A <b>personal pension</b> product which complies with regulations which limit charges and allow individuals flexibility about contributions.
<b>Stakeholder price cap</b>	A 1.5 per cent <b>annual management charge (AMC)</b> for the first ten years of the policy, and thereafter a 1 per cent <b>AMC</b> .
<b>Standard minimum guarantee</b>	The minimum level of income guaranteed to pensioners through the <b>Guarantee Credit</b> element of <b>Pension Credit</b> . (The guaranteed level for some groups of pensioners, such as severely disabled people and carers, who qualify for additional amounts, is higher than the standard minimum guarantee.)
<b>State Earnings-Related Pension Scheme (SERPS)</b>	The forerunner of the <b>State Second Pension</b> , which provides an earnings-related <b>National Insurance</b> pension based on contributions.
<b>State Pension age (SPA)</b>	The minimum age at which an individual can claim their <b>State Pension</b> . It is currently 65 for men and 60 for women born before 6 April 1950. The <b>State Pension age</b> for women born on or after that date will gradually increase to 65 between 2010 and 2020. The Government has proposed increasing the State Pension age for both men and women from 65 to 68, with the first increase from 65 to 66 being phased in between 2024 and 2026 and the subsequent two increases being similarly phased in over two years starting in 2034 and 2044.
<b>State Second Pension (S2P)</b>	The earnings-related <b>National Insurance</b> pension paid in addition to <b>basic State Pension</b> – gives a more generous pension than would have been provided by <b>SERPS</b> for: low and moderate earners; carers who are looking after young children or a disabled person; and long-term disabled people with broken work records. Under the Government's proposed reforms, S2P will be simplified so people will more easily be able to work out the minimum pension they will get from the State. A new flat rate amount of £1.40 a week pension for each qualifying year will replace the great complexity of the existing S2P flat rate calculation. The £1.40 will be revalued with earnings during a working life and with prices in retirement. A residual earnings-related scheme for those earning above £12,500 will gradually be withdrawn over 20 years.



<b>Tax credits</b>	There are two main types of tax credit. Working Tax Credit is an income-related credit for working adults and Child Tax Credit is an income-related credit payable to families with responsibility for children, whether they are in or out of work.
<b>Tax-free lump sum</b>	Twenty-five per cent of pension saving may be taken as a tax-free lump sum. This 25 per cent may include protected rights but not the Guaranteed Minimum Pension.
<b>Tax relief</b>	Individuals making contributions to tax-approved pension schemes receive tax relief at their marginal tax rate (for example, a standard-rate taxpayer will receive tax relief at 22 per cent). Individuals contributing to <b>stakeholder pensions</b> receive tax relief at a minimal rate of 22 per cent. Individuals with very low or no tax liabilities can also receive 'tax relief' at 22 per cent on contributions of up to £2,808 a year. Employers' contributions are made from gross profits and thus are both tax- and <b>National Insurance</b> -privileged.
<b>Tax simplification</b>	The Government introduced a new tax regime for pensions which took effect on 6 April 2006. Simplification has swept away the eight previously existing tax regimes and replaced them with a single universal regime for tax-privileged pension savings. A key feature is that, instead of the annual limits on contributions, there is a lifetime annual limit of £1.5 million of tax-advantaged pension saving.
<b>Trivial commutation</b>	If an individual's total pension accumulation is less than 1 per cent of the lifetime limit on tax relievable pension saving (£15,000 on 2006/07) then individuals are not required to annuitise their fund and can instead take it as a taxable lump sum.
<b>Unfunded pension scheme</b>	Pension schemes that are not backed by a pension fund. Instead, current contributions are used to pay current pensions along with other funds provided by the employer.
<b>Upper Earnings Limit (UEL)</b>	The upper limit on earnings for the purposes of calculating entitlement to the <b>State Second Pension</b> . Also the upper limit for most employee <b>National Insurance</b> contributions. In 2006/07 it is £33,540 a year or £645 a week.
<b>Upper Earnings Threshold (UET)</b>	An intermediate point prior to the <b>Upper Earnings Limit</b> , which affects the accrual of the <b>State Second Pension</b> .
<b>Working-age population</b>	Generally defined as those aged 16 to State Pension age.

## List of abbreviations

---

ABI	Association of British Insurers
ANC	Annual Management Charge
BME	Black and Minority Ethnic groups
DDA	Disability and Discrimination Act
DEL	Departmental Expenditure Limit
GAD	Government Actuary's Department
IMA	Investment Management Association
NAPF	National Association Pension Funds
NDPB	Non-Departmental Public Body
NIC	National Insurance Contribution
NMW	National Minimum Wage
NPSS	National Pension Saving Scheme
OGC	Office of Government Commerce
ONS	Office for National Statistics
PAEB	personal accounts earnings band
PPF	Pension Protection Fund
TPR	The Pensions Regulator



Additional copies of this document are available from TSO (The Stationery Office) bookshops. A list of these are given below.



Published by TSO (The Stationery Office) and available from:

**Online**  
[www.tsoshop.co.uk](http://www.tsoshop.co.uk)

**Mail, Telephone, Fax & E-mail**  
TSO  
PO Box 29, Norwich NR3 1GN  
Telephone orders/General enquiries  
0870 600 5522  
Order through the Parliamentary Hotline  
Lo-call 0845 7 023474  
Fax orders 0870 600 5533  
Email [book.orders@tso.co.uk](mailto:book.orders@tso.co.uk)  
Textphone 0870 240 3701

**TSO Shops**  
123 Kingsway, London WC2B 6PQ  
020 7242 6393 Fax 020 7242 6394  
16 Arthur Street, Belfast BT1 4GD  
028 9023 8451 Fax 028 9023 5401  
71 Lothian Road, Edinburgh EH3 9AZ  
0870 606 5566 Fax 0870 606 5588

**TSO@Blackwell and other Accredited Agents**

This publication, the summary version and the accompanying Regulatory Assessment can be accessed online at [www.dwp.gov.uk/pensionsreform/](http://www.dwp.gov.uk/pensionsreform/)

A Welsh version of the summary is also available at that web address.

A summary version of this report is available free of charge from:

**Pension Guide, Freepost  
RLXH-JUEU-GZCH  
Northampton  
NN3 6DF  
Telephone: 0845 7 31 32 33**

A service for textphone users is available on 0845 604 0210.

The lines are open Monday to Friday, 8am to 8pm, Saturday and Sunday, 9am and 5pm. Please quote code AEPA1

We will consider any additional requests for other alternative formats that may be required.

For any queries or comments on the White Paper please contact:

**Personal accounts white  
paper team  
4th Floor  
The Adelphi  
1-11 John Adam Street  
London,  
WC2N 6HT**

**Tel: 020 7712 2843  
Fax: 0207 962 8613  
E-mail: [personalaccounts-wp@dwp.gsi.gov.uk](mailto:personalaccounts-wp@dwp.gsi.gov.uk)**

ISBN 010169752X



9 780101 697521