Pensions Commission

Implementing an integrated package of pension reforms:
The Final Report of the Pensions Commission

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Implementing an integrated package of pension reforms:
The Final Report of the Pensions Commission

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Members of the Pensions Commission

Left to right: John Hills, Adair Turner and Jeannie Drake

Adair Turner (Chairman)

Adair Turner is Vice Chairman of Merrill Lynch Europe and a director of United Business Media plc. He has recently been appointed as an independent cross bench peer in the House of Lords.

Jeannie Drake

Jeannie Drake is the Deputy General Secretary for the Communication Workers Union and has recently completed her term as president of the Trades Union Congress.

John Hills

John Hills is Professor of Social Policy and Director of the ERSC Research Centre for Analysis of Social Exclusion (CASE) at the London School of Economics.

Implementing an integrated package of pension reforms

Last November the Pensions Commission published its Second Report, setting out our recommendations for pension policy. We were then asked by the Secretary of State for Work and Pensions to keep the Commission in being for several additional months in order to contribute to the public debate about those recommendations. This short document is intended as the final Pensions Commission contribution to that debate. It does not revisit the underlying analysis of the Second Report, nor present entirely new analysis, but it comments on specific issues which have arisen and responds to some of the major arguments presented over the last few months.

The debate since the Second Report has involved detailed contributions from numerous pensions experts and from groups representing employers, employees and the financial services industry. There has been extensive discussion in newspapers and on television and radio. And the National Pensions Day, hosted by the Department for Work and Pensions (DWP) on March 18th, created a forum for discussion by members of the general public. This wide-ranging debate has revealed a high degree of consensus on the direction of policy reform now required. In particular:

- There is almost universal acceptance that the combination of the present state pension system and the present voluntary system of private pension saving is not fit for purpose and will result in pension provision which is increasingly inadequate and unequal.

- There is a significant degree of consensus that the solution must and should entail some combination of higher private pension saving, higher average retirement ages, and an increased percentage of national income spent on state pensions. The fourth option considered in our Reports (pensioners' incomes falling relative to average earnings) is clearly seen as unattractive [Figure 1].

- And there is therefore general acceptance that future policy needs to be based both on significant reforms to the state system and on a new approach to private pension saving which goes beyond a wholly voluntary approach.

In the Second Report, the Commission proposed an integrated set of policies to create a new pension settlement for the 21st century. There were four key dimensions of the integrated approach proposed:

- State system reform to deliver a more generous, more universal, less means-tested and simpler state pension. Over the long term this will require some increase in the percentage of GDP devoted to state pensions and an increase in the State Pension Age. This increase in State Pension Age is fair and appropriate, given increasing life expectancy, provided the detailed implementation is sensitive to differences in life expectancy by socio-economic group.

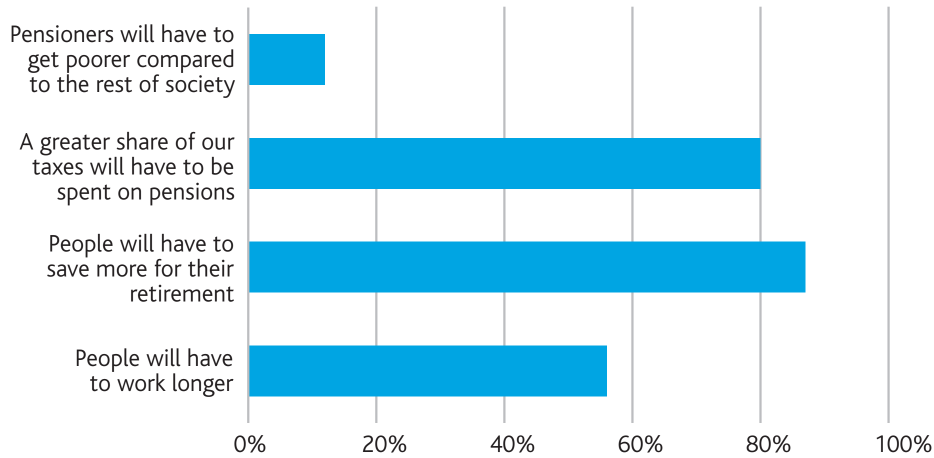
- Strong encouragement to individuals to save for earnings-related pensions through the application of automatic enrolment at a national level.

- A modest minimum level of matching employer contributions to ensure that savings are clearly beneficial for all savers.

- Where there is not good employer-sponsored pension provision, a role for the state as an organiser of pension savings and bulk buyer of fund management to ensure low costs and thus higher pensions and better incentives to save, i.e. the creation of a National Pension Savings Scheme (NPSS) or an equivalent.

Figure 1 Chossing between the 4 options: opinion results from National Pensions Day

To solve the pensions issues in the UK:



Source: End of day results from National Pensions Day UK events. Percentage of individuals who strongly agree or agree.

Note: National Pensions Day was organised by the DWP in conjunction with research based consultants, Opinion Leader Research. Over 1,000 members of the public attended six events held simultaneously across the UK on 18 March 2006 as part of a deliberative consultation exercise. Those attending were asked to consider and vote on the broad framework of the Pensions Commission's proposals.

The figures used in this Report are aggregated UK results based on the number of people attending the events on National Pensions Day. This initial analysis has not yet been weighted to take account of UK demographic and other relevant characteristics. Further detailed analysis is underway.

Specific interested parties and pension experts have proposed variants to the particular elements of this package. And the government faces the difficult challenge of deciding how far and how fast state pension reform can be afforded. Inevitably policy implementation is likely to entail some divergence from the specific recommendations made in the Second Report. But it is vital that:

- Divergences from the specific policies proposed along each of the four dimensions are not so great as to undermine the objectives.
- The four dimensions of policy are seen as forming an integrated whole with parallel progress on all four essential for success.

This document reiterates the key features of the integrated package proposed, and makes further comment on the latter two elements – the employer contribution and the design of the NPSS to ensure low costs – since these have been the subject of extensive debate over the last four months. It is structured in seven sections:

1. Pension trends: latest data
2. State system reform
3. Automatic enrolment
4. Compulsory employer contributions
5. Ensuring low cost savings: the NPSS
6. An integrated package: objectives and trade-offs
7. Securing and maintaining consensus

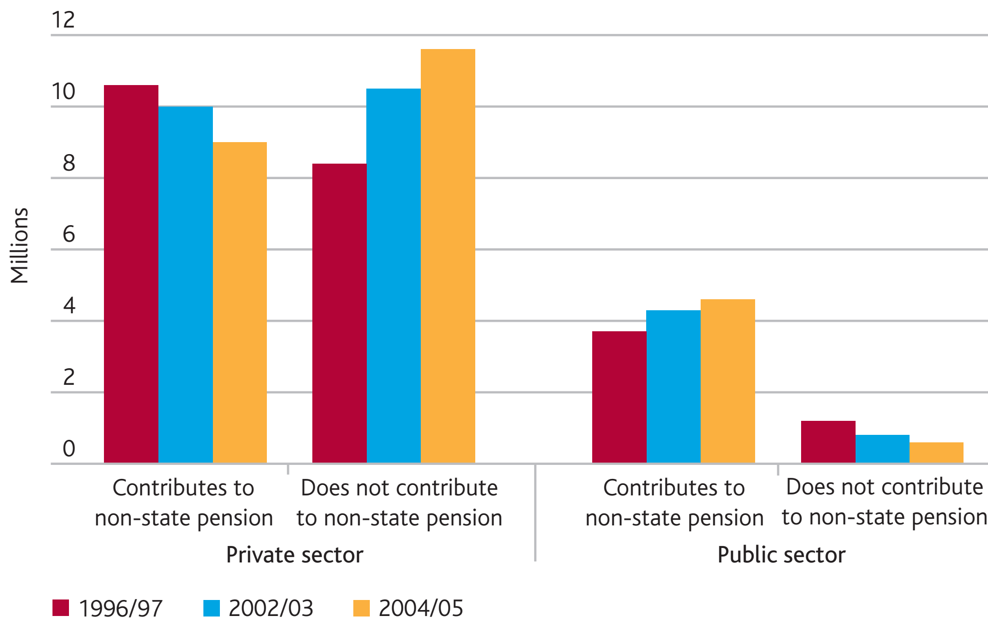
1. Pension trends: latest data

In the four months since the Second Report was published new data on trends in pension provision and pension saving, while inevitably limited, have tended to confirm the analysis of the First and Second Reports. In particular:

- The latest data from the Family Resources Survey (FRS) illustrates that the gradual decline in the percentage of the workforce which has any current pension provision above that provided by the state has continued, with the decline in participation rates for workers in the private sector continuing at a significant pace [Figures 2 and 3]. And the latest Employers' Pension Provision survey shows that the percentage of employers making any pension provision for their employees has declined from 52% in 2003 to 44% in 2005.[1]

[1] The figures for employers making any pension provision include those providing access to a Stakeholder Pension but not contributing. The percentage contributing to a pension for employees is therefore considerably lower.

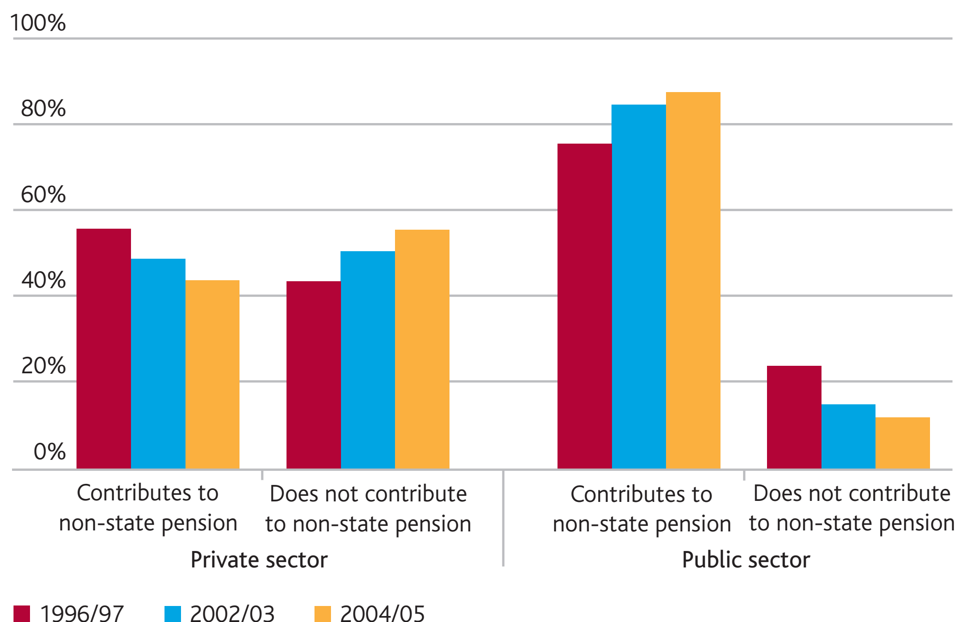
Figure 2 Public and private sector participation in non-state pension schemes: millions



Source: Pensions Commission estimates based on FRS, ONS employment data and Occupational pension scheme surveys, GAD

Note: Data from 1999/2000 onwards are not directly comparable with earlier data. Those individuals with personal pensions that are only receiving contracted-out rebates have been counted among non-contributors since they will only accrue pension rights equivalent in value to the SERPS/S2P rights foregone (assuming that GAD calculations of appropriate rebates are fair). Definition of public and private sector may differ between sources used. Self-employed workers are included in the private sector. Analysis assumes that if an employee in the public sector is not a member of an occupational pension scheme they have no non-state alternative provision. Figures are for GB only. Analysis based on working age people defined as all adults aged 16-59/64. Individuals aged 16-18 who are in full-time education are not included in the analysis. In a small number of cases the contributions referred to will be solely provided by employers and not the employee themselves.

Figure 3 Participation in public and private sector non-state pension schemes: percentage of workforce



Source: Pensions Commission estimates based on FRS, ONS employment data and Occupational pension scheme surveys, GAD

Note: See note to Figure 2.

- While among those private sector companies which do provide pension benefits, the shift from Defined Benefit (DB) schemes to less generous Defined Contribution (DC) provision has continued, with further closures of DB funds to new members, and an increasing trend of closure of funds to new accruals for existing members.

Recognition of these continuing trends, in particular the first, lies behind the extensive consensus that the present system of private pensions will not deliver adequate pension provision, and that policy towards private pension saving needs to move beyond a purely voluntary approach.

2. State system reform

Since the Second Report there has not been extensive debate around the specific details of the Commission's proposed state system reforms. This reflects the fact that the government proposals on state pension reform will not be published until the White Paper, due later in the spring, and the wide consensus that the broad direction of the Second Report recommendations is appropriate. In particular, five propositions have commanded very widespread support:

- That the core function of the state pension system is to provide as generous and as non-means-tested, flat-rate pensions as possible.

- That the UK state pension system needs to become simpler, more generous, and less means-tested than it would become if present indexation arrangements were continued indefinitely.

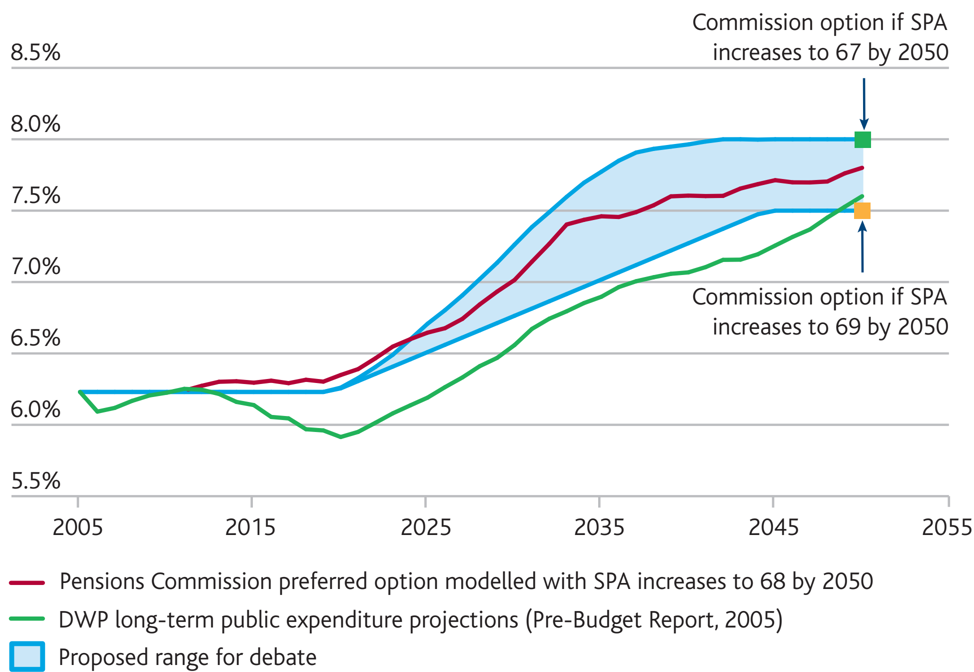
- That it also needs to ensure fairer treatment of people with interrupted careers and caring responsibilities, in particular women.

- That the State Pension Age should rise over the long-term as life expectancy rises but as part of a package whose overall impact is fair, allowing for differences in life expectancy by socio-economic group, and which is accompanied by policies to support flexible retirement and later working.

- And that some increase in the percentage of GDP devoted to state pensions is unavoidable if the objectives set out above are to be achieved, but that this increase can be offset in part by increasing the State Pension Age.

Indeed alternative proposals to the Second Report recommendations have come almost entirely from interest groups and experts who believe that the Commission should have argued for more radical and more rapid action to improve the generosity of the state pension, to simplify it, and to make it less means-tested, even if this implied a much more significant increase in the percentage of national income devoted to state pension expenditure.

Figure 4 The public expenditure versus State Pension Age trade-off: state pension and pensioner benefit expenditure as a percentage of GDP



Source: Pensions Commission analysis using Pensim2 and the DWP long-term expenditure projections from the Pre-Budget Report 2005

The increase in expenditure which actually results will now depend on the detailed proposals which the government brings forward. But further modelling of the package of proposals presented in the Second Report has not suggested any major changes to the cost profile presented there, which suggested that the percentage of GDP devoted to pensions might need to rise by something like 1.5 percentage points between now and 2050, i.e. from about 6.2% today to somewhere in the 7.5 to 8% range in 2050 depending on the level to which the State Pension Age is increased. This is not significantly higher than the expenditure suggested by the Long-Term Public Expenditure projections presented by HM Treasury in the Pre-Budget Report of December 2005 which suggest that expenditure will rise to 7.6% of GDP by 2050, but this increase would still carry significant implications either for tax or National Insurance contribution rates, or for other categories of public expenditure [Figure 4]. Public debate around the acceptability of this increase is therefore essential if a lasting settlement on pensions policy is to be achieved.

It is now for the government to bring forward proposals which balance the needs of pension policy against other claims on public expenditure and against concerns about overall taxation levels at different points in the coming decades. There may, as we suggested in the Second Report, be variants of our specific proposals, or of the timing of implementation, which could reduce the cost, especially in the initial years. But it is important that the specific way forward which is chosen reflects the interconnections between different aspects of policy. In particular:

- The less generous and more means-tested the state system is, the more that people would have to save, for instance through higher minimum contributions to the NPSS, to achieve adequate pensions, but the greater the actual and perceived disincentive that they would face as a result of means-testing.

- More limited progress towards making the state system less means-tested than proposed in our Second Report would therefore imply the need for higher minimum employer contributions to the NPSS to ensure strong and clear incentives for employee participation. Without higher employer contributions, limited success in reducing the spread of means-testing could undermine the success of the NPSS.

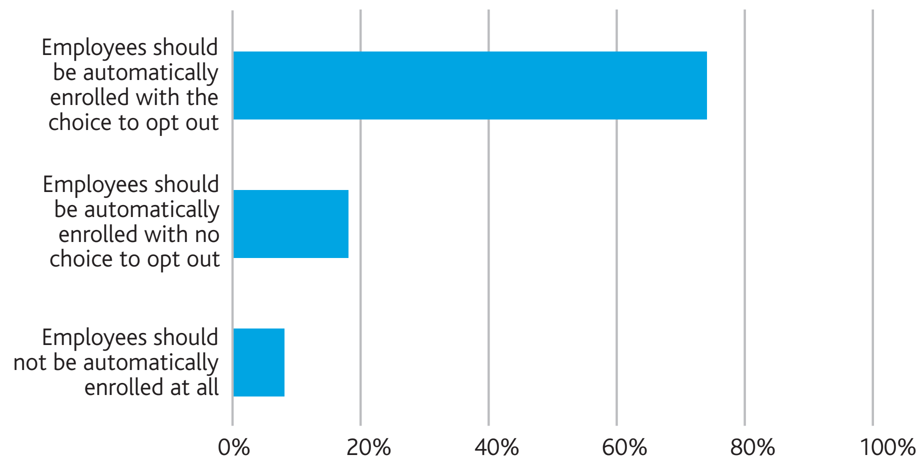
3. Automatic enrolment

A key issue handed to the Pensions Commission, at the time of our establishment, was whether UK pension policy towards private funded pensions needed to "move beyond the current voluntarist approach." The conclusion we reached in our Second Report was that voluntarism was not sufficient, but that it was not appropriate to introduce a system of fully compulsory private saving. Instead we recommended the application of automatic enrolment at a national level to overcome the behavioural barriers to long-term saving, while leaving people ultimately free to make their own decisions.

Debate since the Second Report has revealed a wide-ranging consensus in favour of this approach. All the alternative variants to the NPSS which have been proposed by interest groups since we published our Second Report [see Section 5] are based on the application of automatic enrolment, and there is general agreement that without automatic enrolment it will be impossible to increase pension participation rates significantly or to reduce the costs of pension saving via the elimination of regulated advice costs. This consensus in favour of going beyond voluntarism reflects the weight of empirical evidence that the present voluntary system has not delivered and that initiatives to revive it – such as the introduction of Stakeholder Pensions and of the basic advice salesforce – have had minimal impact. It reflects also the empirical evidence that automatic enrolment, by overcoming inertia, can significantly increase participation rates. It rests crucially on the assumption that state system reform will prevent the further spread of means-testing.

Figure 5 Attitudes to compulsion, automatic enrolment and voluntarism: opinion results from National Pensions Day

Which of the following best describes your views on employees being automatically enrolled into the NPSS?



Source: Results from National Pensions Day UK events

Note: See note to Figure 1.

Disagreement with the Second Report proposals in relation to automatic enrolment have therefore come almost entirely (though only to a very limited extent) from groups and experts who would have preferred a fully compulsory approach. The Commission continues to believe however that automatic enrolment is preferable to full compulsion because:

- The diversity of individual preferences and circumstances means that for some people at particular points in their life, pension saving is not essential or not appropriate, e.g. if people have or will inherit significant housing assets, or if they have high interest rate debt outstanding. Automatic enrolment allows such individuals to opt-out, while providing a strong encouragement to save when it is appropriate.

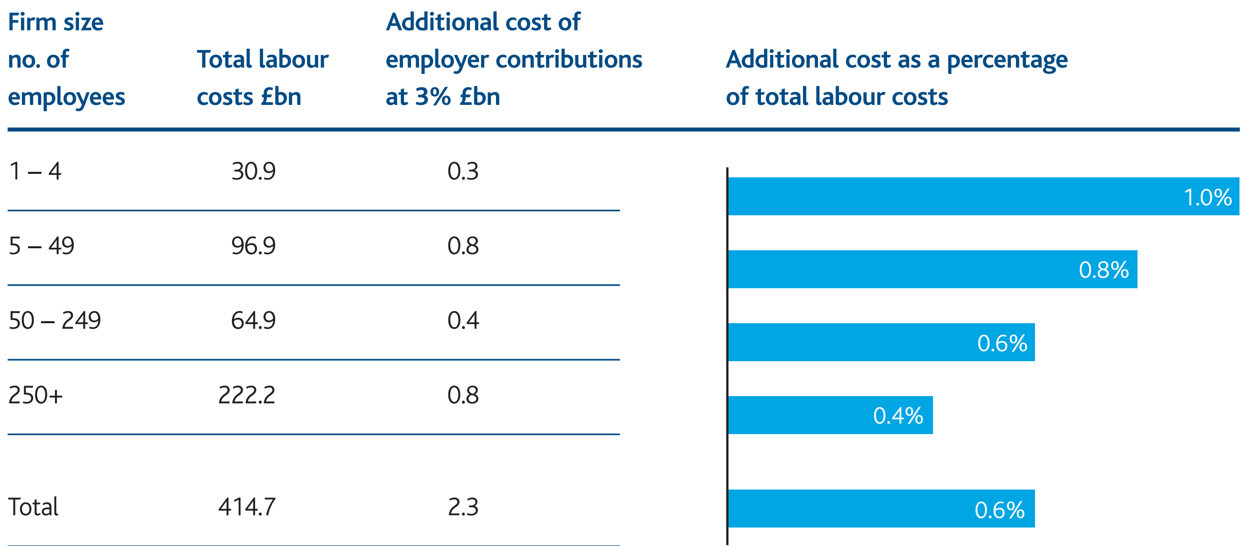
- Pure compulsion would be perceived by many people as equivalent to taxation.

- The evidence of the Pensions Commission's focus groups, and of other opinion research, suggests that automatic enrolment goes with the grain of people's attitudes to the appropriate role of the state, and will command extensive support. For instance, in the National Pensions Day consultation, participants overwhelmingly supported the idea of automatic enrolment with the option to opt-out, as opposed to either fully compulsory contributions or a purely voluntary opt-in system [Figure 5].

4. Compulsory employer contributions

Each of the alternative models for the NPSS proposed by different sectors of the financial services industry has concurred with the Second Report recommendation that there should be a modest minimum compulsory employer contribution (3% of the relevant band of earnings) when an employee accepts enrolment and does not opt-out. This reflects the important role which the employer contribution plays within the overall integrated package. Not surprisingly, however, the proposal of a compulsory employer contribution has been controversial, and several business lobby groups (including the Confederation of British Industry (CBI) and the British Chambers of Commerce) have opposed it, citing the costs which might result for business, and in particular the fact that these costs, as we pointed out in the Second Report, are greater for smaller employers [Figure 6]. While business lobby group opposition to this "contingent compulsion" is not universal (with the EEF: the Manufacturer's Organisation arguing previously for full compulsion), there are clearly legitimate concerns.

Figure 6 Possible impact of a National Pension Savings Scheme on private sector total labour costs



Firm size no. of employees	Total labour costs £bn	Additional cost of employer contributions at 3% £bn	Additional cost as a percentage of total labour costs
1 – 4	30.9	0.3	1.0%
5 – 49	96.9	0.8	0.8%
50 – 249	64.9	0.4	0.6%
250+	222.2	0.8	0.4%
Total	414.7	2.3	0.6%

Source: Pensions Commission analysis of ASHE 2004

Note: Calculations based on 3% contribution (between the Primary Threshold and the Upper Earnings Limit (UEL) for eligible employees not already members of employer-sponsored pension schemes. Analysis assumes that all people who are already members of employer-sponsored pensions receive at least a 3% employer contribution, so that the introduction of the NPSS requires no additional employer contributions in these cases.
It also assumes that there is no "levelling down" of existing provision. As a result, figures could be under or over-estimates of costs. Assuming for all employees aged 21 and over a 65% participation rate for employees with earnings between the Primary Threshold and the Lower Earnings Threshold (LET) and 80% for employees with earnings above the LET and below the UEL. Employer labour costs include total salaries paid plus 12.8% National Insurance on earnings above the Primary Threshold.

The employer contribution is however an essential element within the proposed package and it is likely that without it, participation rates within the NPSS would be significantly reduced. This is because:

- The employer contribution, along with tax relief, means that individual participation in the NPSS at the minimum level receives a "pound for pound match," with 4% out of post-tax earnings supplemented by 1% tax relief and a 3% employer contribution. We believe that, even for the many individuals who will not calculate or consider the impact of the rates of return shown in Figure 7, awareness of this "matching contribution" will provide an important spur to participation. Without it we believe that participation rates will be significantly lower.

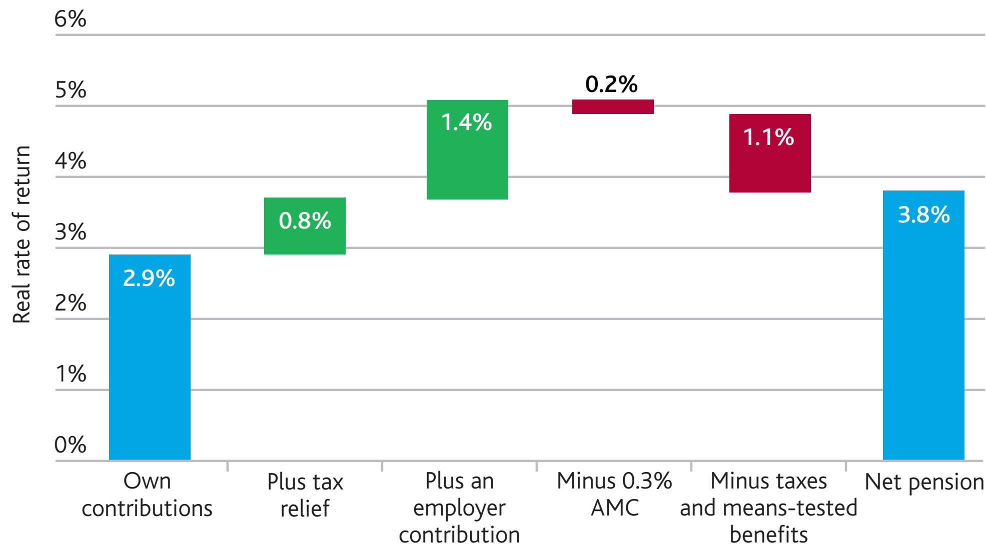
- The absence of an employer contribution would appreciably reduce the rate of return on individual contributions, particularly for those individuals who will still face some means-tested withdrawal of state pension benefits [Figure 7]. Indeed in some extreme cases it could make the rate of return negative.[2] If means-testing cannot be completely abolished, a matching employer contribution plays a critical role in ensuring good incentives to save. The complete abolition of means-testing would, however, imply significantly more public expenditure on state pensions than the Pensions Commission's recommendations imply and more than seems likely to be considered affordable under any government.

- Lower rates of return for individuals, and the possibility in extreme cases of negative real returns, would make it dangerous to proceed with an automatic enrolment system without individual advice, but introducing individual advice would substantially increase costs, and further depress rates of return and pension incomes achieved, negating some of the gains from introducing the NPSS.

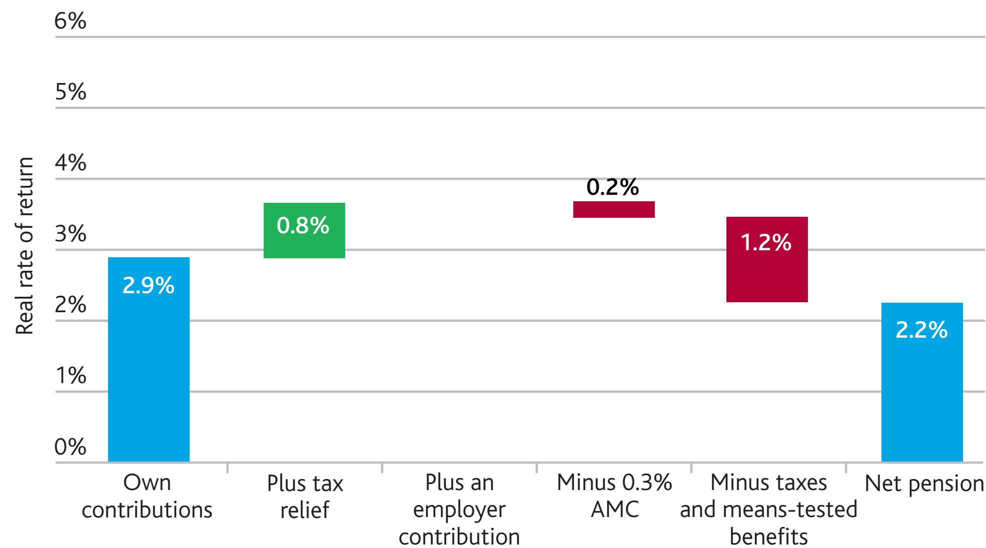
[2] Negative real returns are possible where individuals have broken work records and do not have significant S2P entitlements and face 100% withdrawal on some of their private pension income.

Figure 7 Effective rate of return on saving in the NPSS for someone aged 25 in 2010 who earns £10,000 each year depending on whether there is an employer contribution

Employer contribution



No employer contribution



Source: Pensions Commission analysis

Note: Assumes the state system is as Pensions Commission proposals in the Second Report.
Assumes total contribution of 8% of earnings above £5,000. If there is an employer contribution, it is 3%.
Real rate of return is 3.5%
Earnings increase in line with average earnings each year.
The effective rate of return measures the average return on saving over the lifetime; for both saving and retirement phases after allowing for the impact of the tax and benefits system. This means that the impact of compound interest over time has a significant effect on results, which is why the effect of tax relief and the employer contribution is not to double the return on saving by the individual.
For more details on this modelling see Appendix C of the First Report.

As an alternative to the "contingent compulsion" proposed by the Commission, the CBI has proposed a package of measures which will encourage and "cajole" employers into contributing but leave them with the ability to opt-out [Figure 8].

The possible impact of such measures is difficult to assess but they would almost certainly still leave a high incidence of non-contribution among small and medium-sized employers: indeed if this were not the case, the costs to business of the NPSS, about which the CBI is concerned, would not be reduced. The Commission therefore believes that if contingent employer compulsion were removed the success of the NPSS would be put at risk. If the NPSS was not a success then moderate income earners, particularly those employed by small and medium-sized employers, would be worse off as over time they would not enjoy any element of earnings-related provision either through the State Second Pension (S2P) or through the NPSS.

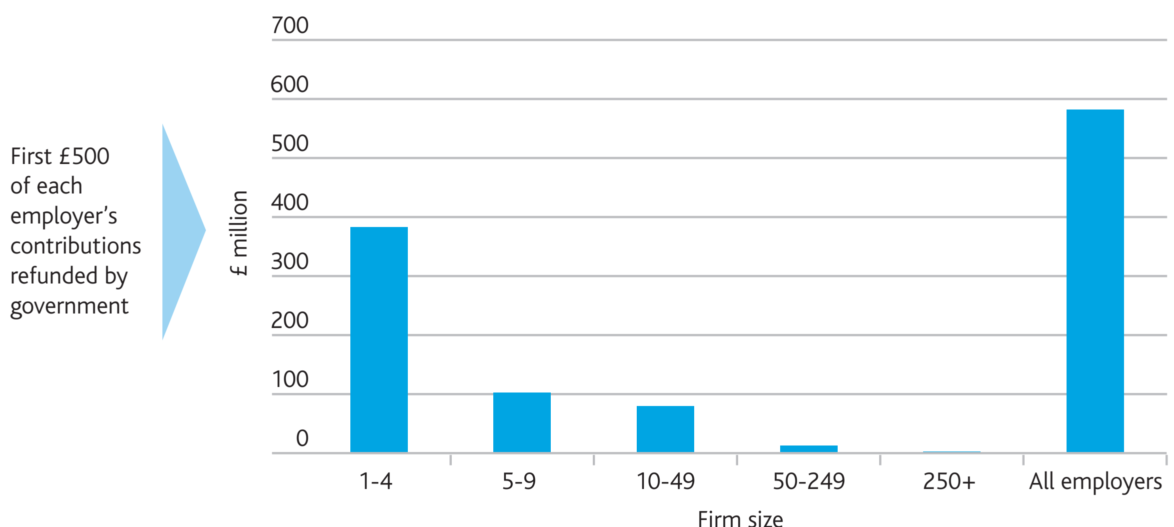
The potential impact of the employer contribution on business costs remains, however, significant. While we suggested in the Second Report that some of these extra costs might be offset over time by adjustments in cash wages (relative to how these would otherwise have developed) there is at least a transition burden, particularly for small businesses. We do not however believe, as some have suggested, that it would be appropriate to exempt very small employers from the scheme, since employees of micro-businesses are a key group of pension undersavers and since an exemption could create incentives for artificial splitting of companies to fall below the size threshold. Instead, we continue to urge the government to consider ways in which the costs for small employers could be mitigated, for instance via subsidies which are fixed as an amount per employer. Figure 9 shows the order of magnitude of the costs of one variant of this approach.

Figure 8 CBI proposed alternative to compulsory matching employer contributions

- Automatically opt-in both employers and employees into an existing occupational pension scheme or the NPSS, but with the option to opt-out for both.
- Require Government to work together with business and trade unions to promote a national "salary sacrifice" pensions campaign – "Pension Builder" – that would make employee and employer contributions more affordable.
- Introduce a new targeted incentive for small employers employing up to 250 employees, at an approximate annual cost of £500m. The Government could choose from two potential incentives:
  - the "Partnership Pension" – providing matching Government contributions to boost pension saving amongst small firms and their employees.
  - a pension tax credit – to incentivise and reduce the cost to small employers of making pension contributions.
- Encourage dialogue between employers and employees regarding whether to participate in a new national savings scheme, by ensuring that employers who choose to opt-out are required to explain this decision to their employees if there is demand for an explanation.

Source: "CBI submission to the Department for Work and Pensions: Responding to the Pensions Commission final report," February 2006.

Figure 9 Cost of subsidising small employer contributions to pension saving: illustrative example



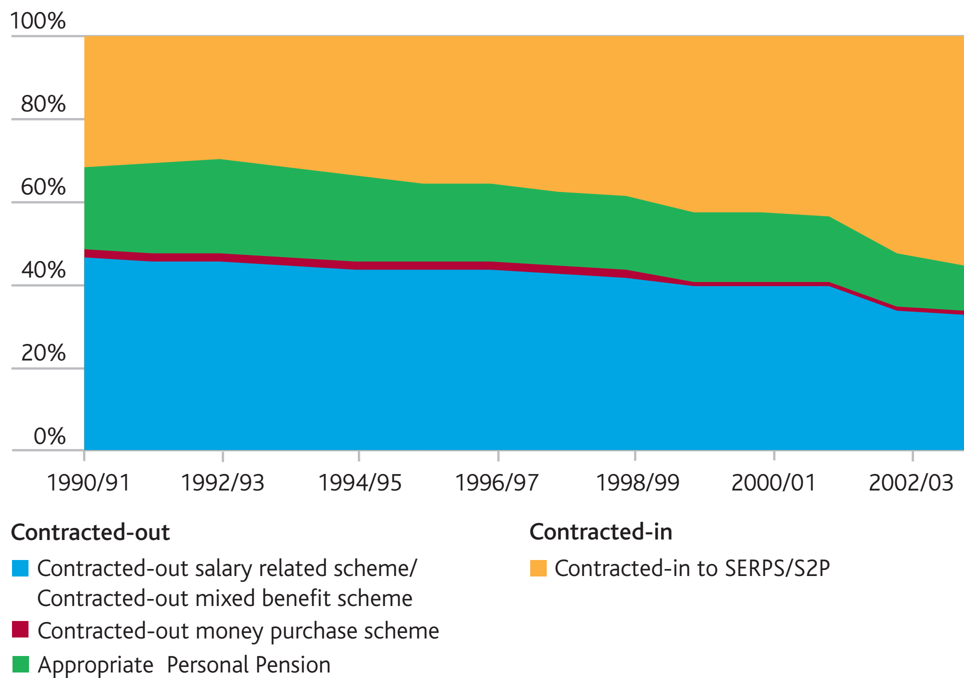
Source: Pensions Commission estimates based on DTI SME Statistics

Note: Estimated costs of refunding the first £500 of each employer's contributions to the National Pension Savings Scheme or to an alternative employer-sponsored pension scheme. Assuming all employers have at least one eligible member.

One potential source of additional revenue out of which to fund such subsidies could arise from reductions in contracting-out rebates. We recommended in the Second Report that these should not be abolished for Defined Benefit (DB) schemes (i.e. that DB schemes should maintain the option of contracting members out of the State Second Pension (S2P)); this reflected our desire not to accelerate further the closure of DB schemes. But it is nevertheless likely that the level of contracting-out rebates paid out will decline, for two reasons:

- First, because the already established trend for people in Defined Contribution (DC) occupational schemes and those with Appropriate Personal Pensions (APP) to contract back in [Figure 10] is likely to be given further impetus by the latest decision on the level of contracting-out rebates, which makes contracting-out unattractive for most people over about 44 years of age [Figure 11].
- Second, because our recommendation in the Second Report that the Upper Earnings Limit for S2P accrual should be frozen in cash terms will significantly reduce contracting-out rebates paid to both DB and DC/APP schemes and policies, compared with existing assumptions.
- In addition, we suggested in the Second Report that there could be a case for accelerating the phasing-out of contracting-out rebates paid to DC schemes and APP policies (i.e. by making membership of S2P mandatory beyond some date except for people in DB schemes).

Figure 10 Second tier pension provision: percentage contracted-in and contracted-out



Contracted-out

- Contracted-out salary related scheme/ Contracted-out mixed benefit scheme
- Contracted-out money purchase scheme
- Appropriate Personal Pension

Contracted-in

- Contracted-in to SERPS/S2P

Source: LLMDB2, DWP

Note: S2P started in 2002/03, this enabled carers and an increased number of low earners to accrue pension rights.

Figure 11 Contracted-out rebates: Government Actuary's recommendations versus proposed level

	GAD recommendations for rebate 2007/08*	Rebate to be applied in 2007/08
Contracted-out salary related	5.8%	5.3%
Appropriate Personal Pensions Age:		
60	13.4%	7.4%
50	9.4%	7.4%
40	7.0%	7.0%
30	5.8%	5.8%

Implication that unless individuals aged over 44 in APPs and 48 in money purchase schemes receive higher investment returns than assumed by GAD, the contracting-out rebate will not replace foregone S2P benefits.

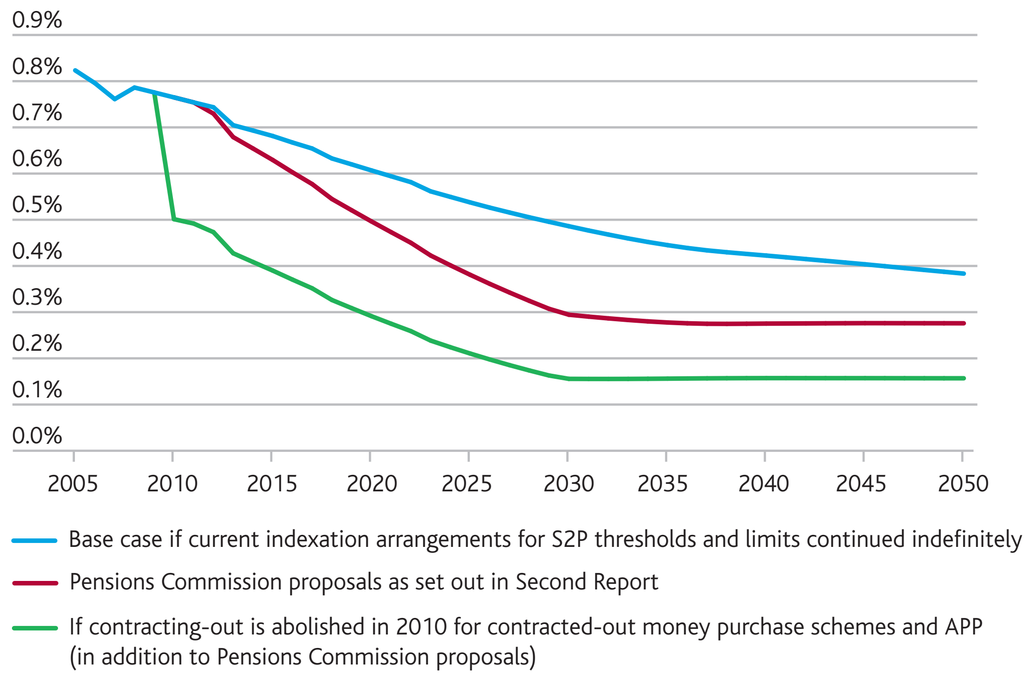
* Assuming: an investment return of 2-4% real per year depending on age; life expectancy in line with the latest GAD forecasts; operating costs (reduction in yield) of 1% in APP.

Source: "GAD & DWP, Review of certain contracting out terms," March 2006.

Even without such a phase-out, the combination of the first two effects will produce very significant increased cash flows for government [Figure 12]. In national accounts terms, these show up as additional government revenue, rather than decreased expenditure. In the Second Report we expressed caution about treating this additional revenue as being available to finance additional current expenditure on state pensions. The revenue has previously, via the contracting-out mechanism, flowed into funded pension schemes and has thus increased national aggregate savings, while reducing the future liability on government to meet future S2P expenditure. Ideally therefore it should continue to be devoted to national savings, rather than to increased consumption. Devoting part of it to measures to help ensure the success of the NPSS, by mitigating the cost of the employer contribution for small employers, would however be an entirely appropriate use, since the money would flow into funded pension saving, and since the NPSS is in part designed to replace the role which the state previously played in compulsory earnings-related pensions via S2P and its predecessor, the State Earnings-Related Pension Scheme (SERPS).

In summary, therefore, we continue to believe that the employer contribution is a vital element in the integrated package we have proposed, but also that the government should identify ways in which the costs to small employers could be mitigated, at least for a transition period, and perhaps permanently. Additional revenue deriving from a falling level of contracted-out rebates could be an appropriate source from which to finance this mitigation.

Figure 12 Expenditure on contracting-out rebates as a percentage of GDP under different options



Source: DWP

Note: The base case projection was compiled at the Pre-Budget Report and assumes the GAD recommended rebates are applied 2007–2012. Actual rebate expenditure will be lower during this period.
The Pensions Commission proposals include the Lower Earnings Limit being increased by earnings and the Upper Earnings Limit being fixed in cash terms.

5. Ensuring low cost savings: the National Pension Savings Scheme

A major focus of debate since the Second Report has been the precise design of the new system for strongly encouraged and low cost pension saving. A number of alternative variants to the NPSS has been proposed by different groups. We set out below the major alternatives proposed and then consider them against four criteria:

- Costs and customer value;
- Operational and set-up risks;
- Investment return risks and governance; and
- The dangers of "levelling down."

The alternative models

Three possible models for a new saving scheme have now been proposed [Figure 13]:[3]

- The original NPSS proposal, set out in the Second Report, which has been supported by the Investment Management Association (IMA) who have also made detailed recommendations relating to appropriate governance arrangements.
- The "Partnership Pensions" model proposed by the Association of British Insurers (ABI), in which people would be automatically enrolled into pension savings accounts held at different insurance companies.
- The National Association of Pension Funds (NAPF) proposal for automatic enrolment into competing, not-for-profit "Super Trusts."

All the models embody automatic enrolment, with the right to opt-out, but a key difference between these models relates to whether there is choice and who exercises choice, both as regards asset class selection and as regards the provider of account administration services [Figure 14].

- In the NPSS model, individuals are free to choose the asset classes in which their fund is invested (though with a default fund for those who make no choice). Neither individuals nor employers choose between providers of account administration services, but the central system would choose between competitive providers of operational services, who would bid for the contract (or contracts) to run the system.

[3] The proposals made by the Pensions Reform Group, led by the Rt Hon Frank Field MP, are in a different category, involving what is effectively the partial funding of the flat-rate state pension.

Figure 13 Alternative automatic enrolment models

Common features	Individuals automatically enrolled by their employers but with the right to opt-out. Individual accounts which are the property rights of individuals.
NPSS	Individual accounts held within single national scheme which provides a range of different investment funds, purchases fund management services at wholesale level, and invests each individual's account in the different funds according to individual's choice.
ABI "Partnership Pensions"	Individual accounts held at one of a number of competing insurance companies. Choice of insurance company is: ■ Primarily driven by employers, ■ With possibility of individual choice override, ■ And with an automatic allocation mechanism, the "carousel," where no choice is specified. Individual choice of asset allocation is as in NPSS.
NAPF "Super Trusts"	Individual accounts held at one of a number of competing non-profit Super Trusts. Choice of Super Trust is: ■ Primarily driven by employers, ■ With an automatic allocation mechanism (perhaps regionally based) where no choice is specified. Trusts are responsible for discretionary asset allocation choices: individual investors receive the pooled return in the whole fund.

Figure 14 Choice and competition in the alternative models

	Account administration services	Investment asset allocation
NPSS	No individual choice – all members hold their account at a single national scheme. But national scheme will purchase outsourced operational services from competing service providers.	Individual free to choose between a range of different asset choices (e.g. equities, bonds) but with default fund available.
ABI "Partnership Pensions"	Employers, individuals, or "the carousel" choose between different competing insurance companies.	Individual asset allocation choice as in the NPSS.
NAPF "Super Trusts"	Employers or the automatic allocation mechanism choose between competing Super Trusts.	No individual choice of asset allocation.[1] Super Trusts make discretionary asset allocation decisions. Varying investment performance of Super Trusts could be a factor in employer choice of Super Trust.

[1] The core NAPF model assumes no individual asset allocation choice, but the NAPF has suggested that it would be possible (though not necessarily desirable) to allow that choice at a later stage.

- The ABI model is identical to the NPSS in respect to asset choice: individual choice is allowed but with default options. However, employers or (probably less commonly) individuals also choose which insurance company holds each individual's account, with an automatic allocation process, the "carousel", if no choice is specified.

- The NAPF model removes individual choice of asset class, giving competing Super Trust trustees the discretion to make appropriate asset class selection on members' behalf.[4] Employers would choose to which of the different Super Trusts an individual was allocated, with that Super Trust also providing account administration services. If the employer did not make a choice, there would again be a system of random allocation to choose the Super Trust.

Costs and customer value: which model of choice and competition is best?

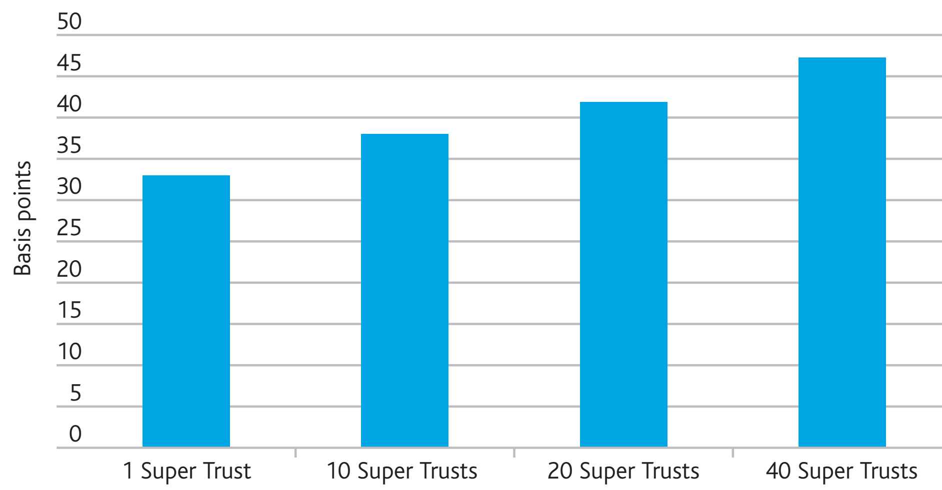
A crucial issue is therefore which of these different models, based on different forms of choice/competition, will deliver the best combination of low cost and value to members.

- It seems to be clear, and is suggested by the cost modelling work undertaken by the Pensions Commission, the IMA, the ABI and the NAPF, that in theory and in the long-term, a single system of the sort proposed by the Pensions Commission and the IMA would have the lowest cost. The NAPF's cost modelling suggests that, in the Super Trust model, the cost of operation would fall as the number of Super Trusts reduces [Figure 15]. Since the NPSS model is, in operational terms, equivalent to a single Super Trust model, this suggests that the NPSS model would be least costly. Similarly modelling work by the ABI, while it suggests that NPSS costs might be somewhat higher than Pensions Commission initial estimates (e.g. in a range of 40-50 basis points rather than 30 b.p.[5]), is believed to suggest that the multi-provider model proposed by the ABI might have costs of around 60 or 65 b.p..[6]

  These higher "theoretically attainable" costs for the multi-trust or multi-company models reflect the fact that the introduction of choice between different trusts or companies will produce some movement of accounts between providers, which will generate some additional costs.

4 Individual asset choice could be supported in the Super Trust model, if trustees felt that allowing wider choice would be in the interests of members.
5 One basis point (b.p.) is 0.01% thus 30 b.p. is the same as 0.3%
6 The ABI has argued that it is difficult to be definitive about the costs of Partnership Pensions, or the NPSS as so many elements are uncertain. However they have said Partnership Pensions would be likely to have charges of half the current level, which is around 130 b.p.

Figure 15 NAPF estimates of Annual Management Charges for Super Trust model



Source: NAPF, "Super Trusts putting members first: NAPF alternatives to NPSS," February 2006

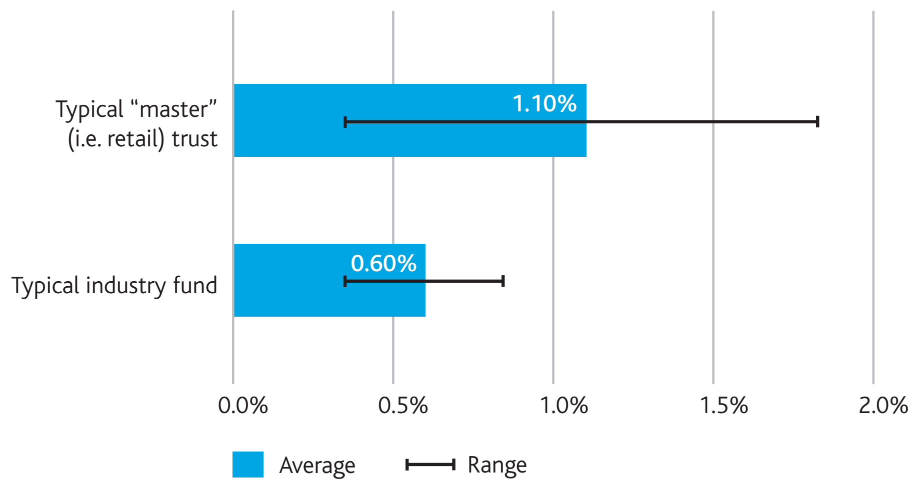
- As important as the "theoretically attainable" costs, however, is whether actually achieved costs would tend towards the lowest level possible, or would be inflated by unnecessary cost proliferation. This depends crucially on which model of choice/competition will be most effective at keeping costs down in this specific market, or, if competition is ineffective in driving cost reduction, how effective regulation can be in achieving the same result. The judgement of the Pensions Commission is that on this criterion, the NPSS model is likely to have advantages. This is because:

  – In the ABI and NAPF models, motivation for cost reduction would have to derive either from the pressure of choice and competition (employers choosing lower cost companies/trusts and thereby creating an incentive for providers to reduce costs) or from regulatory pressure (e.g. a price cap). But it is unclear that employers would exercise choice in a way which created an incentive for cost reduction, and there would be a danger that competition to influence employer (or individual) choice would take the form of high expenditure on brand advertising. This appears to have been the case in Australia, where despite a fully compulsory system, total costs have remained high [Figure 16]. But there are also dangers in a price cap approach, since, while it is possible for government to legislate a maximum price, it cannot force private suppliers to serve the market at that price. As a result, less economic segments of the market (in particular median and low earners in small and medium-sized companies) could go unserved, or, if the carousel forced suppliers to take their share of such customers, suppliers might exit the scheme entirely.

  – In the NPSS model, cost minimisation would be achieved via competitive bidding for the contract to provide administrative services.[7] In a market where the power of choice exercised by individuals or small employers to drive competitive cost reduction may be limited, a model in which an economy of scale agent (the central system) chooses between alternative providers is likely to be more efficient.

[7] It would indeed be possible in the NPSS model not only to have competitive bidding between alternative providers of account administration services, but to divide the contract between different providers (rather than awarding on a winner takes all basis) thus allowing comparison of cost and service quality over time. The NPSS model might not therefore be radically dissimilar in terms of operational delivery from the NAPF model with a small number of Super Trusts (but with a quite different approach to investment management choice).

Figure 16 Typical Annual Management Charges within the Australian compulsory savings system



Source: Bateman, Kingston and Piggott, Forced Saving, 2001

Note: Master or retail trusts are schemes run by banks or life insurance companies.
Industry trusts are multi-employer schemes which achieve significant economies of scale.

The issue therefore becomes whether the likely higher costs of the multi-trust or multi-company models would be justified by value benefits deriving from consumer choice. Two different categories of consumer benefit from competition could be proposed:

- Better customer service (e.g. more responsive call centres, fewer errors in account maintenance). On this, the judgement to be reached is similar to that relating to cost minimisation: whether a choice exercised by employers or individuals is likely to prove a more effective incentive to provide higher quality service than choice exercised by a central system purchasing from competing operational services providers. The argument could be made either way.

- Better investment management performance, with the NAPF proposing that employers would, over time, select the Super Trusts which delivered superior investment performance. It is unclear however that employers (and in particular smaller employers) are well placed to exercise informed judgement about the relative likely future investment performance of different trusts, given the well established difficulties of inferring future relative performance from past results.

The Pensions Commission is therefore not convinced that the alternative models would deliver a set of member benefits which have a sufficient value to the consumer to justify the somewhat higher long-term costs which those models are likely to produce.

The issue of the precise charges which can be achieved in the NPSS (or any of the alternative models) is less certain and to some extent less important. The choice between the alternative models is largely unaffected by whether, for instance, the NPSS can be run at 30 b.p. and a ten trust model at 40 b.p., or whether the best estimates are 40 b.p. and 50 b.p.; what matters is the relativity. However it remains the Pensions Commission's judgement that the indicative target suggested in the Second Report (30 b.p.) remains a reasonable ballpark figure for those members who choose investments in passive index-tracking funds.

- It is important in cost estimates and cost comparisons to be clear what assumptions are being made on fund management costs. All of the cost models presented have tended to assume that most members will and should invest in passive index funds, and have therefore assumed fund management costs of about 10 b.p.. Clearly, however, if individuals are given freedom to choose actively managed funds (a possible option in both the NPSS and ABI models) fund management costs will be higher for those making that choice.

- The crucial issue is therefore how low operational costs can be driven. The NPSS estimate of 30 b.p. for total costs assumes operational costs of 20 b.p.. This seems a reasonable benchmark at which to aim given that the Swedish Premium Pension System actually charged members 22 b.p. in 2005 with a forecast reduction to 19 b.p. in 2006 and to much lower rates in future. Since the Swedish system is fully compulsory, avoiding the complexities of automatic enrolment and opt out, this will tend to result in lower costs relative to the NPSS. But conversely, the average Swedish account size is depressed by the lower contribution rate (2.5% of relevant earnings rather than the proposed minimum 8% for the NPSS). With many of the costs fixed per account, this would tend to increase the percentage charged.

Overall therefore the Pensions Commission believes that the NPSS model of a single national system purchasing operational services from competitive contractors is likely in the long run to deliver the most favourable combination of low cost and member benefits, and that a benchmark of 30 b.p. for total costs remains a reasonable target at which to aim.

Operational and set-up risks

The establishment of the NPSS involves significant operational set-up risks, and these would not be eliminated by outsourcing the operations. The implementation of the system must therefore be very carefully planned. An argument put in favour of the ABI model is that insurance companies are already operating large numbers of individual pension accounts, with IT systems, call centres, and communication mechanisms in place. A similar argument can be made with regard to pension funds already operating large numbers of individual pension accounts (although in many cases the administration is outsourced to the same companies which could compete to provide administration services to the NPSS). An important trade-off which government therefore needs to make is between the likely long-term cost benefits of a single NPSS approach, and the potentially lower operational risks of building on existing infrastructure.[8]

[8] One possibility is that insurance companies, as owners of existing infrastructure, might be among those who would bid to provide operational services to a single NPSS.

Investment return risks and governance

Proponents of alternatives to the NPSS have also suggested that a single national scheme creates risks for the government since individual members may be disappointed with the investment return achieved. This disappointment could arise either:

- Within a specific age cohort, with some individuals making what in hindsight turn out to have been less successful asset allocations than others.
- Between age cohorts, with different generations achieving different returns as a result of different equity market performance even if invested in the default fund (which by appropriate shifts in the proportion of the fund invested in equities over working life could reduce but not wholly eliminate differences between cohorts).

These risks need to be recognised. But it seems likely that they could actually be more severe, and more of a problem for government, under the alternative models proposed, since:

- In the ABI model different insurance companies might deliver different returns even for the same asset class, opening the government to criticism for having allowed employers and, in some cases, the "carousel" to allocate individuals to pension investments of varying performance.
- In the NAPF model, different Super Trusts are almost certain to deliver varying returns, since they will make different discretionary asset allocation decisions. Individuals allocated to poorer performing trusts by their employer or by a default allocation system are likely to feel aggrieved. Denying members the freedom to make an asset allocation choice, rather than mitigating the risk to government, may therefore increase it.

Comparison of the risks involved in the alternative ways of implementing automatic enrolment, suggests therefore that the risks to government may be higher within the systems with multiple providers, particularly where individuals are not making their own choice of provider. Within the NPSS model, either an individual makes his or her own conscious choice of portfolio, or has funds invested in the default fund alongside other NPSS members. By contrast, where individuals are allocated by employers or by a carousel between multiple providers, individuals could, at least retrospectively, claim that they had been encouraged to save and automatically assigned to funds which had performed relatively poorly.

This discussion illustrates the fact that the only way to remove risk entirely from the individual is for someone (e.g. insurance company, employer or government) to absorb it. The only proposal which largely removes investment risk from the individual is therefore that proposed by the Pension Reform Group, which does so by giving the board of the Universal Protected Pension the right to vary compulsory contribution rates, essentially outsourcing from government taxation-equivalent decisions. The Pensions Commission, as we set out in Chapter 5 of the Second Report, does not believe this is a politically feasible way forward. And there is indeed no "nil risk" solution either for individuals or for government, since doing nothing is also risky, leaving many individuals with inadequate pension and government with the political consequences of this inadequacy.

As a result individuals will inevitably bear some investment return risk. The challenge is therefore to ensure that these risks are clearly explained in the literature provided, and that it is clear that the only fund whose return the government can guarantee is one invested in real indexed government bonds held to maturity (but with low risk accompanied by very low returns).[9] This challenge is already faced by the many Defined Contribution (DC) occupational schemes which allow individuals to choose between different asset classes. The precise range of asset class choices made available, and the design of the default fund, will however be extremely important decisions. Appropriate design of the NPSS governance structure, to ensure professional competence and independence from government, will therefore, as the IMA have argued, be an extremely important issue.

Existing schemes and the dangers of "levelling down"

One criticism which has been made of the NPSS proposal is that it might encourage "levelling down" from existing pension provision, i.e. that companies faced with the need to automatically enrol employees either into their own existing scheme or into the NPSS and faced with a defined national minimum contribution will reduce employer contribution rates. Since average employer contribution rates to DC schemes are presently about 6%, this risk clearly exists. But it would not be eliminated by the alternative models proposed, it cannot be considered a reason for rejecting the automatic enrolment approach, and measures can and should be taken to reduce it.

[9] In practice even government bonds held to maturity will involve some degree of risk, since it may not be possible to construct portfolios composed of gilts maturing in each member's year of annuitisation, particularly given that annuitisation dates are not known in advance but subject to member choice.

- The alternative models proposed differ along the dimensions illustrated in Figure 13. But in all of them automatic enrolment would be used to increase participation rates, and in all there would be contingent compulsion on employers to contribute a defined minimum amount if the employee stayed enrolled. It is these common features, rather than the NPSS's specific features, which create the danger of a levelling down effect. Any system which increases participation rates will create the risk that some employers will seek to offset increased costs by reducing contributions for those already enrolled; and any system which establishes a minimum employer contribution rate cannot avoid the danger that this is seen as defining an acceptable employer standard.

- The risk of levelling down cannot however justify rejecting automatic enrolment, nor justify rejecting a minimum matching employer contribution. As Figure 3 showed, an estimated 56% of the private sector workforce including the self-employed now has no occupational or personal pension provision to supplement state provision, and this proportion is growing, up from 51% in 2002/03, and 44% in 1996/97. With state pension provision becoming increasingly flat-rate and, even under the Pensions Commission's proposals, becoming on average less generous, the priority must be to increase funded pension saving among those who have no private pension provision, even if this increases somewhat the danger of levelling down for the minority who already enjoy some private provision.

- Moreover if the risk of levelling down to the NPSS minimum is severe, there must be a significant danger that employer pension provision will in any case decline, since the danger of levelling down implies that many employers are currently including higher employer pension contributions in their total remuneration packages with no confidence that these are playing an economically efficient role in recruiting and retaining people of appropriate skills. Indeed in the absence of an NPSS minimum this levelling down could be to a floor of 0% rather than 3%.[10] The most reasonable judgement may be that without an NPSS, this "levelling down to zero" effect would occur in many small and medium companies, but that whether or not the NPSS were implemented many large companies would continue to provide pension contributions significantly above NPSS minimum standards. This would be because they see such pension provision as both tax-efficient remuneration and essential to their positioning in the labour market.

[10] The latest Employers' Pension Provision survey suggests evidence of this "levelling down to zero efffect," with the percentage of employers making no pension provision for employers rising from 48% in 2003 to 56% in 2005. The 44% of employers who are making any pension provision in 2005 include employers who provide access to a Stakeholder Pension but no contributions. The percentage of employers making contributions is considerably lower.

This in turn suggests that the launch of the NPSS or indeed any alternative system involving automatic enrolment and minimum employer contributions should be accompanied by the communication of important messages which seek to counter the levelling down risk.

- Clearly explaining that for most individuals the minimum default contributions (5% plus 3%) will not be sufficient by themselves to deliver conventional standards of pension adequacy, and that something like double that level is likely to be required (on reasonable return assumptions and in combination with likely state provision), to achieve, say, a 65% replacement rate at the point of retirement. This will help increase job seekers' interest in the pension contributions offered by different companies. The NPSS is not intended to be a replacement for good occupational provision and should not be presented as such. It is a proposal for a low cost pension saving scheme where there is not good employer-sponsored pension provision.

- Always describing the 5% plus 3% contribution level as a minimum, thereby sending the message that any employer who wishes to be considered a good employer needs to provide more than this minimum.

- Explaining with examples the important fiscal benefits of paying people in part through employer pension contributions. Employer pension contributions, unlike cash wages, are not subject to employer National Insurance contributions or employee National Insurance contributions. A significantly better value benefit to employees can therefore be delivered at the same cost to the employer even before the benefits arising from personal income tax relief which apply to both employer and employee contributions.

In summary, therefore, the key defence against long-term levelling down is to convince employers and employees that employer contributions are a desirable form of remuneration, actively valued by employees and offered by employers to secure labour market recruitment and retention objectives.

6. An integrated package: objectives and trade-offs

The previous sections have argued that the overall shape of the recommendations made in the Second Report continues to be appropriate, and a significant level of consensus has emerged in favour of each of the key dimensions of policy proposed. On each specific element of the package, different experts and interest groups have of course argued for different specific approaches, and have identified disadvantages of the proposed approach relative to specific desirable objectives.

Concerns have been expressed that the path proposed towards a simple state system is slower, and the reduction in means-testing less radical than is ideal. But that reflects the fact that these desirable objectives have to be traded-off against other equally important considerations – the need for a transition from the present system which does not create arbitrary winners and losers, and the need to contain public expenditure costs to a sustainable level which can secure public and cross-party support.

In the Second Report, we set out 12 criteria relevant to the optimal design of a new pension settlement [Figure 17]. No set of policies can achieve an ideal result against all of these criteria simultaneously. The aim of policy should therefore be to achieve the best balance between these different criteria. The package we recommended in the Second Report aims to strike that balance.

There will of course be specific details on which government implementation of a new approach is likely to differ from the Second Report recommendations, and even beyond the White Paper later this spring, there will be many decisions still to be made (for instance on the detailed design of the NPSS). What is essential, however, is that the policies implemented form a coherent and integrated whole, and that in particular the interconnections between state system design and private pension policy are clearly recognised. In particular:

- State pension system reform to reduce the future spread of means-testing, and to create a simpler, more understandable system on which people can build and benefit from additional savings, is essential to the success of the NPSS (or of any of the variants of an automatic enrolment system proposed as alternatives).
- But state pension system reform alone is insufficient to solve pension adequacy problems, and an acceleration of the state system's evolution towards a flat-rate (and therefore simpler system) and away from earnings-related provision, would not be appropriate unless an alternative form of strongly encouraged earnings-related provision was simultaneously created, via some form of NPSS (or its alternatives).
- The employer contribution is an essential element of the package, and would become even more important if public finance constraints required that the reduction in means-testing were less extensive or less rapid than was proposed in the Second Report. Indeed the less progress is made towards the abolition of means-testing, the higher the minimum employer contribution would need to be.

Figure 17 Criteria for assessing pension reforms

1. Simplicity	Reforms should make the system (either immediately or over time) simpler and more understandable.
2. Public expenditure cost	Cost should fall within proposed envelope, accepting that some increase in spend as a percentage of GDP is inevitable but: – Ensuring long-term stability of spend as a percentage of GDP after one-off increase. – Avoiding significant increase in the next 10 to 15 years as a percentage of GDP.
3. Distributional impact: – Protecting the poorest	Lowest income earners should enjoy the same replacement rate from state pensions as they do today, preserving recent improvements.
4. Distributional impact: – Avoiding unnecessary beneficiaries	Reforms should avoid significant increases in public expenditure which benefit those pensioners who are already well provided for.
5. Adequacy	Reforms (to private and state systems) should make it likely that the typical earner will achieve at least a 45% replacement rate on retirement
6. Cost efficient savings	...while enabling them to achieve a higher replacement rate at low cost, delivering to all people the potential for low cost saving.
7. Reduced means-testing	The scope of future means-testing should fall significantly below that which would arise if current indexation arrangements were continued indefinitely and preferably from current levels, with: – Major reduction in the percentage of pensioner households potentially subject to 40% withdrawal. – Minimal offsetting increase in the percentage of pensioner households subject to 100% withdrawal. – Reduction in the percentage of pensioner households requiring means-tested benefits to lift them up to the state minimum.
8. Avoiding harm to the existing voluntary system	Reforms should minimise the danger of accelerated closure of private sector Defined Benefit schemes or the levelling down of voluntary employer provision to minimum standards.
9. Improving the position of women: – Future pensioners	Looking forward women should be better enabled than at present to build up independent rights, and to secure full state pension rights, despite interrupted careers and caring responsibilities.
10. Improving the position of women: – Today's pensioners	Some improvement should be made to limit the gaps and inequities created by the inherited system.
11. Improving options for the self-employed	Reforms should make it more likely that the self-employed can gain adequate state pensions and access to low cost saving.
12. Robustness in the face of rising longevity	All elements of the pension system (unfunded or funded) must be made affordable in the face of rising longevity and of major uncertainty about the speed of that increase, while putting in place measures which recognise the inequalities created by different life expectancies of socio-economic groups.

7. Securing and maintaining consensus

Whatever the precise package of measures which the government now brings forward, it will be essential that these secure as much public and cross-party support as possible, and thus increase the likelihood that the new pension settlement will be sustainable. British pension policy for decades has been bedevilled by a lack of continuity. One consequence of this is a profound lack of trust in government pension promises, which have been changed so many times that few people understand what is now planned, and few trust that what is planned will be delivered. But the success of overall pensions policy depends crucially on people understanding clearly what pension the state will and will not provide, and therefore what they and their employers need to provide on top, and on confidence that incentives to save are good and will remain relatively stable over time. Nor should this be an impossible aspiration. Other countries (for instance the US and Sweden) have managed to create understandable and trusted state systems which have remained fairly stable over long periods of time, or which have been reformed, with cross-party support, in ways set out far in advance and maintained through changes in government.

Responsibility for creating cross-party consensus over the next year or so rests with government and with the present leadership of the opposition parties. But over the long-term the likelihood that consensus can be maintained, and that the inevitable adjustments to policy can be made with continued cross-party support, could be improved if debates on pension policy were informed by independent analysis of key trends in demography and pension provision. We therefore reiterate our recommendation, made in the Second Report, that a permanent Pensions Advisory Commission should be created, charged with monitoring developments and laying before Parliament every three to four years a report describing relevant trends and spelling out the unavoidable trade-offs which result. The key issues for that Commission to consider are set out in Figure 18.

Figure 18 Key issues for the Pensions Advisory Commission

- Latest best estimates of future life expectancy and thus of the unavoidable future trade-off between increased public expenditure and increased State Pension Ages. Including analysis of:
  - Whether gaps in life expectancy by socio-economic group are closing, widening or staying constant.
  - Evidence on whether ageing is on average "healthy" (more years of active life) or "unhealthy" (more years of frail, dependent life).
- Latest trends in private pension provision, and of participation and contribution rates within the NPSS, and thus of the overall coverage and adequacy of pension provision.
- Analysis of trends in average retirement ages, and in employment rates among older people.

List of abbreviations

Abbreviations	Description
ABI	Association of British Insurers
AMC	Annual Management Charge
APP	Appropriate Personal Pension
ASHE	Annual Survey of Hours and Earnings
b.p.	basis points
CBI	Confederation of British Industry
DB	Defined Benefit
DC	Defined Contribution
DTI	Department of Trade and Industry
DWP	Department for Work and Pensions
FRS	Family Resources Survey
GAD	Government Actuary's Department
GDP	Gross Domestic Product
IMA	Investment Management Association
LET	Lower Earnings Threshold
LLMDB2	Lifetime Labour Market Database
NAPF	National Association of Pension Funds
NPSS	National Pension Savings Scheme
ONS	Office for National Statistics
S2P	State Second Pension
SERPS	State Earnings Related Pension Scheme
SME	Small and Medium-sized Enterprise
SPA	State Pension Age
UEL	Upper Earnings Limit