Pointmaker

REINFORCING AUTOMATIC ENROLMENT

A RESPONSE TO THE DWP'S CONSULTATION

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SUMMARY

- Later this year the Department of Work and Pensions (DWP) will publish the outcome of its Automatic Enrolment (AE) Review.
- This paper makes some proposals to help maintain the low rate of AE opt-out. It is crucial that individuals are provided with a stronger sense of personal ownership over their savings.
- This can be achieved by introducing highly personalised Lifetime and Workplace ISAs into the AE arena. With simplicity in mind, the latter could reside within the Lifetime ISA: a single savings vehicle to serve until death, requiring only one line of communication (with the provider). AE-generated savings should be as personal as one's bank account.
- The Terms of reference of the AE Review refer to ensuring value for money for the taxpayer. In order to achieve this, the Treasury's Income Tax relief and NICs rebates should be scrapped and be replaced with a highly redistributive 50% bonus paid on the first £2,000 of post-tax contributions (paid by employee or employer), and 25% on the next £6,000 (i.e. an annual bonus cap of £2,500): This could the Treasury save at least £10 billion a year, while catalysing a much broader savings base.
- The use of "band earnings" in calculating automatic enrolment contributions should be replaced with "total earnings", capped at £40,000. AE's minimum contribution rates for employees and employers should both be raised by 1%. After including the bonus, contributions would then total 13.5% of total earnings, on the first £2,000 of contributions, and 11.25% on the next £6,000.
- This paper considers the impact on total retirement incomes: lower earners and the self-employed do particularly well.
- There are 12 specific proposals, particularly designed to benefit low earners, the self-employed, the young, and employers.

TWELVE PROPOSALS

Proposal 1: The AE Advisory Group should emphasise the importance of pension dashboard utility for engagement with workplace saving, notably the ability to consolidate disparate pension pots into one pot.

Proposal 2: Given the AE Review's remit to ensure value for money for the taxpayer, it should consider the implications, for AE contribution and opt-out rates, of replacing Income Tax relief and NICs rebates with a redistributive 50% bonus paid on the first £2,000 of post-tax contributions, and 25% on the next £6,000, i.e. an annual bonus cap of £2,500, paid irrespective of tax-paying status.

Proposal 3: Automatic enrolment contributions from employees under the age of 50 should be eligible to be paid into a Lifetime ISA, attracting a bonus.

Proposal 4: Automatic enrolment contributions from employers, and employees aged 50 and above, should be eligible to be paid into a Workplace ISA, attracting a bonus. The Workplace ISA would share the annual bonus cap with the Lifetime ISA. Tax-free withdrawals could be made from the age of 60. The Workplace ISA, which could reside within a Lifetime ISA.

Proposal 5: The Lifetime and Workplace ISAs should be regulated in the same way as workplace DC pensions schemes, including a charge cap. They should have the same Inheritance Tax treatment as pensions pots, and be excluded for means testing purposes.

Proposal 6: The minimum age for automatic enrolment should be lowered to school leaving age, thereby including apprentices, for example.

Proposal 7: AE's minimum earnings threshold of £10,000 should be scrapped.

Proposal 8: The use of "band earnings" in calculating automatic enrolment contributions should be replaced with "total earnings", capped at £40,000.

Proposal 9: Class 4 NICs (self-employed) should be increased by 3% to match Class 1 NICs (employees), characterised as bonus-eligible "auto-contributions" to a Lifetime ISA (for those under 50) or otherwise a Workplace ISA. These should be accompanied by a default which would redirect the 3% to HMRC, triggered by non-payment of a bonus-eligible "quasi-employer" contribution. The latter could, to some degree, count as a tax-deductible business expense. Both auto-contributions and quasi-employer contributions could be ramped up in the style of AE, increasing in 1% annual increments, to 3% each by 2020, say.

Proposal 10: The minimum AE contribution rates for employees and employers should be raised by 1%, to total 9% of total earnings. Proposal 2's bonus structure would take total contributions to 13.5% of total earnings on the first £2,000 of employee and/or employer contributions, and 11.25% on the next £6,000.

Proposal 11: "Auto-protection" should be introduced, with two distinct components:

(i) "auto-drawdown" at private pension age, in the form of an annual income drawdown default of between 4% and 6% of pot assets, paid monthly; and

(ii) "auto-annuitisation" of residual pots, perhaps twenty years after private pension age.

Proposal 12: The AE Advisory Group should encourage the Government to reconsider its opposition to NEST developing mass market decumulation products, to include a collective drawdown capability to enable retirees to pool their longevity risk.

1. INTRODUCTION

Automatic enrolment (AE) has, to date, been a success. The opt out rate is around 10% but, to its credit, the Government is not resting on its laurels. It has not forgotten a 2009 assessment that anticipated an opt out rate of 21.8% by March 2019, and 27.5% thereafter. And while the DWP has recently acknowledged that the assumptions used in 2009 are now out of date, uncertainty remains.

Meanwhile, the pensions and savings landscape, and the labour market, are not static. Since AE roll-out began in 2012, we have seen the introduction of the new State Pension, pension freedoms (ending the annuitisation requirement) and the Lifetime ISA, welcomed by Generation Y, in particular, as they eschew pension pots' inflexibility. Ownership of the first home ranks far ahead of saving for a pension.

For AE to continue to be a success, opt out rates have to be kept low, at under 15%, say: Generation Y has to be got on board, and be kept there.

2. THE STATE OF PLAY

2.1 So far, so good

At end-May 2017, almost 8 million workers had been automatically enrolled into a pension scheme, with over 598,000 employers declaring their AE compliance.[1] They include 136,000 small and micro employers who started the process in the first three months of 2017, but some 800,000 to 900,000 employers are yet to do so (including 600,000 who should start by the end of 2017). By programme conclusion, in 2019, some 1.4 million companies are expected to have set up new retirement funds for around 11 million workers.[2]

2.2 From here on: tougher

AE opt-out rates have been encouragingly low to date, but AE faces significant headwinds, including:

(i) "phasing" (i.e. ramping up) of statutory minimum contributions which, for employees, are set to quintuple between now and April 2019, from 0.8% to 4% and, for employers, to treble to 3%.[3] This will take total minimum contributions to 8% of band earnings[4] (including 1% tax relief, at the basic rate);

(ii) the increasing number of small and micro employers reaching their staging dates, many without HR Departments to dissuade employees from opting out;[5] and

(iii) the prospect of rising mortgage rates, notwithstanding the overhang of QE: the interest rate cycle will eventually turn. This, potentially combined with ongoing stagnant earnings growth, would squeeze disposable incomes.

Given all this, it would be reasonable to anticipate a rise in opt-out rates over the next few years. In addition, the number of companies missing their AE "staging dates" is rapidly accelerating. A year ago only 1% of firms were late in setting up workplace pensions; in March 2017 this figure had leapt to

1 *Automatic enrolment declaration of compliance report, July 2012 – end May 2017*; The Pensions Regulator, June 2017.

2 TPR data.

3 Minimum contributions are increasing in two phases. The first increase must be in place from 6 April 2018 and the second from 6 April 2019.

4 2017-18 tax year band earnings: between £5,876 and £45,032 a year (as per the National Insurance contributions' Lower and Upper Earnings Limits, respectively).

5 Small employers: 5 to 49 employees; micro employers: 1 to 4 employees.

16%.[6] This is an (unsurprising) consequence of AE roll-out having reached the long tail of smaller companies yet to commence phasing. The low hanging fruit (i.e. the larger companies) has been harvested.

2.3 Millions are ineligible for AE

The DWP criteria for AE starts with excluding:

(i) the self-employed; and

(ii) members of DB schemes, and members of DC schemes with employer contributions of more than 3%.

This leaves roughly 14.7 million workers out of a total workforce of 32 million,[7] 24% of whom then fail on other AE criteria:

(i) roughly 2.8 million people (19%) earning below the AE earnings trigger of £10,000 in any one job; and

(ii) a further 730,000 people (5%) who meet the earnings criterion but fail the age criterion, being under the age of 22 or over State Pension age.[8]

Thus, while 11.2 million workers fall into AE's eligible target group, many others are excluded, predominately women (primarily because their earnings are too low).[9] Perhaps Treasury-incentivised contributions into any pension pot (including workplace schemes) should be split 50:50 with a pot for the contributor's spouse?

6 Aviva data.

7 UK labour market: June 2017; ONS, 14 June 2017. There are also 1.5 million unemployed and 19.2 million inactive (mostly pensioners): a total over-15 population of 52.7 million.

8 *Workplace pensions: Update of analysis on Automatic Enrolment 2016*; DWP, October 2016.

9 Ibid.

3. ENGAGEMENT

3.1 Workplace pensions

(a) A flawed perspective

Today, workplace pension schemes are set up from the wrong perspective, with the employer / provider relationship pre-eminent. Employers choose their providers, and then, typically, the funds selection works primarily for the employer (low risk) and provider, not necessarily for the employee. A recent survey of auto-enrolled scheme members found that an extraordinary 39% of those surveyed were unaware that they were a member of a workplace pension scheme.[10] It also found that 95% had never tried to change their fund, 91% did not know where their funds were invested, 80% did not know how much was in their pension pot and 34% did not know who their pension provider was.

Engagement is clearly lacking, partly because being a member of a nebulous occupational pension scheme does not engender a sense of personal ownership. Few scheme members have, for example, identified a beneficiary after they die. AE-derived savings should be as personal to the employee as his bank account.

(b) Widely scattered pots

Employer-sponsored pensions schemes are impractical: they are not, for example, readily portable when an employee moves jobs, thereby leaving him with a littoral of disconnected pots. Hence the need for the pensions dashboard. The review of AE should take the opportunity to reiterate the importance of the dashboard, and to stress that utility is essential for engagement. The dashboard has to be more than an observation platform: people must be able to do things with it, notably to consolidate disparate pots into one pot.

10 Decision Technology. Survey size: 906 auto-enrolled scheme members.

Proposal 1: The AE Advisory Group should emphasise the importance of pension dashboard utility for engagement with workplace saving, notably the ability to consolidate disparate pension pots into one pot.

3.2 Pension pots: for many, an unattractive savings vehicle

(a) Complicated and distrusted

The AE Advisory Group's Terms of Reference indicates that one of the objectives behind strengthening engagement is that employees are better enabled to understand and maximise savings. Years of evidence makes it clear that the pensions saving vehicle is not understood by most people, notwithstanding numerous efforts to educate the general public. Impenetrable jargon (Uncrystallised Fund Pension Lump Sum?) combined with a surfeit of regulation present huge barriers to communicating pensions in a simple language. In addition, the pensions industry is distrusted, which does not encourage engagement.

(b) Inflexible

For many people, the biggest deterrent to saving in a pension pot is the lack of any access to savings until private pension age (currently 55, which is too early: it should be 60).[11] For Generation Y,[12] in particular, ownership of their first home ranks far ahead of saving for a pension, which partly explains why contributions to personal pensions are falling behind contributions to the more flexible stocks and shares ISA (Table 1), notwithstanding that only the former come with an upfront incentive.

3.3 Incentives

(a) Income Tax relief and NICs rebates: ineffective

Income Tax relief is not well understood by many (most?) adults, and is often considered to be insufficient to overcome the barrier that is pension pots' lack of access, as well as the

[11] Rising to 57 in 2028, and thereafter set at ten years below the State Pension age.

[12] Generation Y (aka millennials): those born between 1980 and 2000, i.e. aged 17 to 37 today.

Table 1: ISA vs. personal pensions contributions, £ billion

	Stocks and shares ISA	Personal pensions incl. self-employed*	S&S ISAs / personal pensions
2008-09	£9.7	£9.0	108%
2015-16	£21.4	£9.7	221%

**Includes basic rate tax relief*

Sources: *Individual Savings Account (ISA) Statistics,* Table 9.4; HMRC, August 2016, and *Personal pensions statistics,* Table PEN 1; HMRC, February 2017.

Table 2: The rapidly rising cost of pensions' tax reliefs, £ billion1

	2014-15	2015-16	*Change*	
Tax rellief on employer contributions	£19.9	£22.8	15%	*£46.1 in cash*
Tax relief on employee contributions	£7.3	£7.6		
NICs rebates on employer contributions*	£13.7	£15.7	15%	
Untaxed pension pot income & capital gains	£7.7	£7.9		*Tax foregone*
25% lump sum (author estimate)	£4.5	£5.0		
Total	**£53.1**	**£59.0**	**11%**	
less Income Tax paid by pensioners	£13.0	£13.4		
Net cost to HM Treasury	**£40.1**	**£45.6**	**14%**	

** Includes foregone employee NICs due to salary sacrifice schemes (est. £2bn.)*

Source: *Table PEN 6: Cost of Registered Pension Scheme Tax Relief; HMRC, February 2017.*

industry's poor reputation. And because Income Tax is progressively structured, tax relief is regressive. Consequently, it is iniquitously distributed, mostly going to the wealthy, who are in least need of it: tax relief is an ineffective use of Treasury resource. As if to reiterate this point, the ONS has just released the latest household savings ratio, for Q1 of 2017: 1.7%, a record low.[13]

In addition, most of the NICs rebates on employer contributions directly benefit company shareholders (some are in respect of public service schemes): they are invisible to employees, and therefore unappreciated.

(b) Rapidly rising cost

Table 2 shows the net cost of the two reliefs, up £5 billion in the last year, partly as a consequence of AE's success.

Once AE has been fully rolled out, in 2019-20, annual workplace savings are expected to have increased by £17 billion: £6.4 billion and £8 billion in additional employer and employee contributions, respectively, plus £2.5 billion of additional tax relief.[14] In addition, with the Personal Allowance set to rise to £12,500 (by 2020), the number of pensioners paying any Income Tax is set to fall further (it is already below 50%).

Given budgetary pressures, it is hard to envisage pensions-related tax reliefs eluding the Chancellor's attention for long. And this would become even less likely if increasing AE's 8% total minimum contribution were to become a declared objective.

[13] *Monthly economic commentary: June 2017*; ONS, 30 June 2017.

[14] *Workplace pensions: Update of analysis on Automatic Enrolment 2016*; DWP, October 2016.

(c) Terrible value for money for the taxpayer

The AE Advisory Group's Terms of Reference specifically state that it should have regard to s149 of the Equality Act and the principles of fairness, affordability and sustainability….through ensuring value for money for the taxpayer. It is extremely unclear how, at a cash cost of £46.1 billion, and rising rapidly, Income Tax relief and NICs rebates fulfil this objective.

(d) Reframe required: "bonus"

The author has long campaigned for all pensions Income Tax relief and NICs rebates to be scrapped (total 2015-16 cash cost £46.1 billion).[15] We should consider a much more redistributive incentive, disconnected from tax-paying status to address the progressive / regressive conundrum, and reframed as a "bonus" (as with the Lifetime ISA).[16]

One example would be a 50% bonus on the first £2,000 of post-tax contributions, and 25% on the next £6,000, i.e. an annual bonus cap of £2,500 (equivalent to an annual allowance of £8,000). This structure would be significantly redistributive, doubling the rate of saving incentive for basic rate taxpayers (84% of working adults) on the first £2,000 saved.[17]

With employer NICs rebates gone, the bonus should also be payable on employer contributions, sharing the annual bonus cap with employee contributions.

[15] *Table PEN 6; Cost of Registered Pension Scheme Tax Relief*; HMRC, February 2017.

[16] See *A pensions and savings manifesto for 2017*; Michael Johnson, CPS, April 2017.

[17] This is not necessarily intuitive. Today, basic rate taxpayers receive tax relief of 25p per post-tax £1 saved (£1.25 pre-tax, less 20% Income Tax of 25p). A 50p bonus paid on a pre-tax £1.25p = 40%.

Proposal 2: Given the AE Advisory Group's Terms of Reference requirement to ensure value for money for the taxpayer, it should consider the implications, for AE contribution and opt-out rates, of replacing Income Tax relief and NICs rebates with a redistributive 50% bonus paid on the first £2,000 of post-tax contributions, and 25% on the next £6,000, i.e. an annual bonus cap of £2,500, paid irrespective of tax-paying status.

3.4 Engagement: a conundrum?

It is no secret that automatic enrolment harnesses inertia, and that the low opt out rates experienced (to date) are partly a consequence of apathy, i.e. disengagement. So, should raising engagement be a specific policy objective?

Opinions are divided. Ruston Smith, one of the AE Advisory Group chairs, has said that the AE review was about "how to improve engagement to increase a sense of personal ownership".[18] He cited the USA's "mature 401(k) culture" and that young people "who are not in 401(k) plans actually understand them and talk about them, so how can we create that?"

However, with engagement would come some understanding of the pensions industry's cultural attachment to complexity, opacity and obfuscation. The resulting distrust risks reducing any inclination to save. This is likely to be a contributory factor in NEST's research which suggests that the understanding that can follow engagement encourages some people to opt out of AE.[19]

That said, few would dispute the benefit to society of encouraging people to assume more personal responsibility for their long-term financial well-being. That requires engagement, and the earlier the better, not least to provide time for people to discover things for themselves (such as the positive power of compounding) through active mental participation ("heuristic development").

But we have to ensure that engagement leads to positive experiences for the saver, and we have to be realistic: many people will never engage, and our savings framework should accommodate them too.

4. PUT WORKERS FIRST

4.1 Harness the Lifetime ISA

Surveys repeatedly evidence that the Lifetime ISA is likely to prove popular with Generation Y. It will help fulfil a pressing need and a tangible outcome (home ownership) that is likely to be far more immediate than a retirement income.

Capita, for example, found that 32% of 16 to 34 year olds would prefer to use an ISA to save for retirement than a pension, with just 26% disagreeing.[20] Dunstan Thomas reported a positive reaction to the Lifetime ISA from almost all the millennials surveyed, prompting it to conclude that "the government could have a major success on its hands".[21] Hymans Robertson found that 61% of workers under the age of 40 said that they would open a LISA.[22]

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18 Speaking at the Pensions and Lifetime Savings Association's 2017 Investment Conference.

19 Paul Todd, NEST's Director of Investment Development and Delivery. See *Pensions Expert*, 9 March 2017.

20 Capita; *Educate and engage; Employee Insight Series 2017*, a survey of some 1,800 UK employees in January 2017.

21 Dunstan Thomas commission market researcher Opinium to survey (online) 1,000 millennials, results being fed directly from smartphones into the database. Encouragingly, 71% had heard of the Lifetime ISA.

22 Survey of attitudes towards the Lifetime ISA, conducted in autumn 2016.

Of these, 23% said that they planned to do so "straight away" (interpreted as being in the first year). There are c.18 million people in the LISA's 18 to 40 age range, c.80% of whom are employed, i.e. 14.4 million. If Hymans' survey results were to become reality, 8.8 million people could be expected to open a LISA, including 2.0 million who would do so "straight away".[23]

Currently, this figure feels high because some potential Lifetime ISA providers have yet to enter the market: some are still developing their systems, and others could be holding back in an attempt to protect their pensions franchise.

4.2 The Lifetime ISA: a threat to AE?

Some have suggested that the LISA could be so attractive that it will encourage employees to opt out of AE, thereby missing out on their employer contributions. This message requires some untangling, for it is rare indeed for a savings vehicle to be described as "too attractive". The (pensions) industry's angst is, of course, self-serving, and disregards the fact that many within Generation Y are already prioritising saving for a home over contributing to a pension pot. Some within the industry would appear to forget that this is the age of the customer.

In the autumn of 2016, Aon Hewitt asked 600 pensions industry professionals about the AE opt-out risk. 58% responded that the Lifetime ISA would have "no material impact"; 38% said it would be "modest"; and only 2% said "significant".

However, the Pensions and Lifetime Savings Association (PLSA) reported that 40% of 18- to 39-year-olds would opt out of their workplace pension in favour of a Lifetime ISA.[24] A similar figure (36%) was produced by True Potential, a Lifetime ISA provider, which also said that it expected 46% of people to also save in a pensions products. In addition, an FT Money survey of 1,008 people aged 18 to 39 found 38% agreeing that they would "prefer to pay into a Lifetime ISA instead of a pension, even though this could mean losing employer contributions and tax relief". That said, most people regarded the Lifetime ISA as an "as well as" product that they will hold alongside a pension.

The allure of property ownership is reinforced by ONS data showing that only 24% of people see workplace pensions as the best method of saving for retirement; nearly twice as many (46%) cited property, with which the Lifetime ISA is closely associated, as the best option.[25]

Inevitably, the conclusion is that that we do not know what impact the Lifetime ISA will have on AE opt-out rates: probably "limited". Given that (i) Generation Y like the Lifetime ISA; and (ii) we do not want to risk compromising auto-enrolment's success, the prudent response should be to include the Lifetime ISA within the AE framework.

4.3 Lifetime ISA: an opportunity to reinforce AE

Auto-enrolled employees should be allowed to choose where to direct their contributions, between their employer's own occupational

[23] This is, however, unlikely to happen this year. Few industry providers were offering the Lifetime ISA at inception (April 2017), primarily because of insufficient preparation time: product details only appeared eight months ahead of launch.

[24] PLSA commissioned ICM Research to conduct online interviews of 895 people aged 18-39, April 2017 (i.e. ahead of the Lifetime ISA launch).

[25] ONS data based upon research carried out from July 2014 to June 2016.

pension scheme (attracting tax relief), a LISA (attracting a bonus), and some other AE-approved route, including NEST.

Unlike a corporate savings vehicle, a Lifetime ISA bears the owner's name: it is a highly personalised savings vehicle, which engenders a sense of being in control. People refer to "my" LISA, but "the" workplace scheme. In addition, LISAs provide ready access to contributions: pension pots provide none until private pension age.

Such flexibility encourages engagement, fuelled by the LISA's proximity to property. Consequently, including the LISA within AE would likely help discourage AE opt outs (at a time of rising headwinds) and perhaps even motive people to save more.

Proposal 3: Automatic enrolment contributions from employees under the age of 50 should be eligible to be paid into a Lifetime ISA, attracting the bonus.

Meanwhile, the Lifetime ISA's 6.25% "surcharge" on non-property-related withdrawals made before 60 should be eliminated, by reducing the penalty charge from 25% to 20%.[26] This would establish economic symmetry vis-à-vis the bonus.

[26] Most people do not appreciate that the 25% penalty is not the same as the 25% bonus. A post-tax £100 LISA contribution would attract a £25 bonus. If a 20% penalty were applied to the total £125, then the saver would receive a net £100, ending up "square". As it is, he will have to repay 25% of £125, leaving him with £93.75, i.e. bearing a £6.25 "loss", or surcharge.

4.4 A Workplace ISA for employer contributions[27]

Employee engagement with saving would be further enhanced if employees could choose where their employer contributions reside. A Workplace ISA should be introduced into auto-enrolment's legislated embrace, as an alternative to the employer's proffered occupational scheme. The key features:

- employer contributions to a Workplace ISA (taxed at the employee's marginal rate) should attract the same Treasury bonus as the Lifetime ISA, up to an annual bonus cap shared with contributions to LISAs and pension pots;
- withdrawals from the Workplace ISA should not be permitted until the age of 60; thereafter, they would be tax-free;
- post-50 employee contributions (and allied bonuses) would be directed to the Workplace ISA (the LISA being shut from the age of 50); and
- Workplace ISA contributions and bonuses could be invested in a low-cost, diversified default fund, with an "opt-out" for employees wanting to direct their own investments. (A similar default could be attached to the Lifetime ISA.)

There is no reason why people should require multiple savings vehicles: simplicity demands a single vehicle to serve from cradle to grave, accommodating workplace and all other savings. The Workplace ISA could be housed within the Lifetime ISA, which would also bring employer contributions closer to the individual: see Figure 1.

[27] Detailed in *The Workplace ISA*; Michael Johnson, CPS, April 2016.

Introducing the Lifetime/Workplace ISA combine into the auto-enrolment arena would reinforce AE. It would address any concerns that the Lifetime ISA is encouraging employees to opt out of AE, thereby missing out on employer contributions. The initiative would also help meet the Government's request of the AE Advisory Group to advise on how to provide a stronger sense of long-term personal ownership, and strengthen the engagement of individuals with workplace pensions.

Proposal 4: Automatic enrolment contributions from employers, and employees aged 50 and above, should be eligible to be paid into a Workplace ISA, attracting a bonus. The Workplace ISA would share the annual bonus cap with the Lifetime ISA. Tax-free withdrawals could be made from the age of 60. The Workplace ISA, which could reside within a Lifetime ISA.

4.5 Lifetime and Workplace ISA: protections

Lifetime and Workplace ISAs should benefit from the same consumer protections that are afforded to workplace DC pensions schemes, under the auspices of The Pensions Regulator (TPR). This should include a charge cap on any default funds, the same Inheritance Tax treatment as pension pots, and exclusion for means testing purposes.

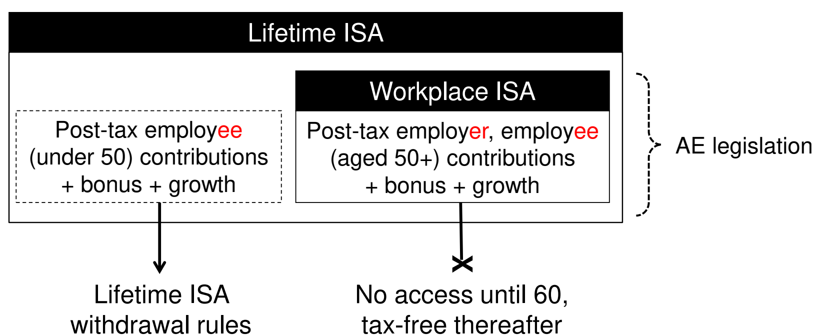
Proposal 5: The Lifetime and Workplace ISAs should be regulated in the same way as workplace DC pensions schemes, including a charge cap. They should have the same Inheritance Tax treatment as pensions pots, and be excluded for means testing purposes.

4.6 Young workers

The minimum age of 22 for automatic enrolment is arbitrary, serving no consumer purpose. It should be lowered to school leaving age so that apprentices, for example, have an opportunity to start receiving employer contributions and accumulating savings early. This change should accompany the inclusion of the Lifetime / Workplace ISA within the AE framework. Young workers would appreciate, perhaps more than any other age group, the Lifetime ISA's flexibility relative to the traditional, inflexible, pensions pot.

Proposal 6: The minimum age for automatic enrolment should be lowered to school leaving age, thereby including apprentices, for example.

Figure 1: The Workplace ISA within the Lifetime ISA



4.7 *Low earners*

(a) Scrap the minimum earnings threshold

Today, low earners miss out on AE employer contributions, and tax relief on their own contributions, because of AE's £10,000 minimum earnings threshold. It is unclear what (consumer) purpose it serves: it certainly does not help those in multiple (low earning) jobs.[28] Consequently, the threshold should be scrapped.

In addition, those in multiple low-earning jobs are unable to aggregate their incomes for AE purposes, and low earning members of "net pay" workplace schemes miss out on tax relief.

These injustices would be rectify by:

(i) replacing Income Tax relief and NICs rebates with the aforementioned bonus structure. The crucial change is that bonuses would be paid irrespective of tax-paying status (as per the Lifetime ISA today); and

(ii) scrapping AE's £10,000 minimum earnings threshold.

> **Proposal 7:** AE's minimum earnings threshold of £10,000 should be scrapped.

(b) Multiple jobs: determining contributions

Simply removing the minimum earnings threshold would not fully address automatic enrolment's maltreatment of low earners; many have multiple jobs, and the basis on which contributions are calculated, by reference to band earnings, would still significantly disadvantage them. Someone with three jobs, for example, each paying £6,000 per year, would suffer three deductions of the Lower Earnings Limit (LEL, £5,876 this year) in the contributions calculation process.

This could be addressed by HMRC aggregating earnings after the end of the tax year, and then communicating with both the individual and each employer their "share" of the LEL deduction (on a *pro rata* basis), and the contributions due. But substantial delays in contribution payments would be inevitable.

Perhaps now is the time to remove the Lower Earnings Limit, thereby addressing a significant issue with automatic enrolment: many (most?) people do not appreciate that today's total 8% minimum contributions rate does *not* refer to total salary: it is equivalent to only some 6.3% of median earnings.[29]

The relevance of "band earnings" would disappear, to be replaced with "total earnings", simplifying the process of determining contributions.

> **Proposal 8:** The use of "band earnings" in calculating automatic enrolment contributions should be replaced with "total earnings", capped at £40,000.

This change would facilitate an increase in the size of contributions, without raising the headline percentage rate. Employers may complain, which may be an appropriate time to remind them that the Corporate Tax rate has been cut from 30% to 19% in the last decade, and is scheduled to be 17% for 2020-21.

Everyone should be limited to a single Lifetime ISA / Workplace ISA provider (not least to reduce the risk of excessive bonus payments, capped at £2,500 per year).

(c) Major advantages for low earners

These proposals would hugely benefit low earners, because:

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[28] Its origin lies in protecting the vested interests of pensions industry antediluvians.

[29] Median earnings were c. £28,000 in 2016, for a full time employee.

(i) a saving incentive would be available to those even with total earnings below the Personal Allowance;

(i) inability to aggregate earnings from multiple jobs (for tax relief purposes) would become irrelevant; and

(iii) low earning members of "net pay" workplace schemes would no longer miss out on a saving incentive (tax relief having disappeared). Today, this problem afflicts some 280,000 workers earning between £10,000 and the Personal Allowance (£11,500 currently). It is set to become worse as the Personal Allowance rises to £12,500 (by 2020), perhaps then impacting around 500,000 workers. But the issue would be resolved by disconnecting the saving incentive from tax-paying status, in the form of bonuses; and

(iv) savers' communication needs would be simplified to a single Lifetime/Workplace ISA provider, rather than with multiple workplace schemes.[31]

5. THE SELF-EMPLOYED

5.1 Persevere, with auto-contributions

The 4.6 million self-employed are ineligible for AE, and very few of them are making any provision for retirement: 17% according to the DWP. HMRC reports an even lower figure for the number of self-employed who made any contribution in 2014-15: 380,000 (a mere 8%), the average annual contribution being £4,090.[32] Meanwhile, they pay Class 4 NICs at 9%, 3% less than employees' Class 1 NICs, yet they accumulate the same State Pension entitlement.[33] This is unreasonable.

The 2017 Spring Budget is remembered for the Chancellor's ignominious U-turn on increasing Class 4 NI contributions for the self-employed.[34] This is unfortunate but understandable, given that such a move would have broken a promise made in the Conservative's 2015 election manifesto (not to increase NI rates until 2020).

But the Chancellor was right to look at the issue of the inconsistencies between different employment groups....and we now have a new government with no such commitment to freeze NI rates. He should persevere.

Pre-Budget, a variety of NICs-related proposals were proffered to encourage the self-employed to save. These include increasing Class 1 NICs to match Class 4 NICs, with the self-employed then being able to elect for the 3% increase to be diverted into a pension pot or Lifetime ISA, subject to a minimum contribution from themselves.

The 3% increase should be implemented, perhaps characterised as bonus-eligible "auto-contributions" to a Lifetime ISA (for those under 50) or otherwise a Workplace ISA (within a Lifetime ISA), ideally held at NEST (or one of its competitors). These should be accompanied by a default which would redirect the 3% to HMRC, triggered by non-payment of a "quasi-employer" contribution.

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31 This would obviate the need for a pensions dashboard for the next generation of workplace savers,

32 *Personal Pension Statistics Table PEN 3;* HMRC, February 2017.

33 There are subtle differences between the thresholds of the two NICs Classes.

34 The intention was to raise Class 4 NICs from 9% to 10% in 2018 and then to 11% in 2019.

5.2 *"Quasi-employer" contributions*

Automatically enrolling the self-employed is confronted by the perennial problem of the absence of an "employer" contribution. Perhaps a new category of contributor could be created (the "quasi-employer") whereby the self-employed, as "quasi-employer", could make bonus-eligible contributions to a Lifetime or Workplace ISA (depending upon age). And, to a modest extent (50%-weighted, say), perhaps these could also count as a tax-deductible business expense, to ripple through the beneficiary's Income Tax return? The Treasury should, however, be careful not to over-subsidise the self-employed.

Both auto-contributions and quasi-employer contributions could be ramped up in the style of AE, increasing in 1% annual increments, to 3% each by 2020, say. It is unlikely that many people would exercise the default, by not paying quasi-employer contributions, to then see the additional 3% in NICs go to HMRC rather than a savings vehicle with their name on it.

Proposal 9: Class 4 NICs (self-employed) should be increased by 3% to match Class 1 NICs (employees), characterised as bonus-eligible "auto-contributions" to a Lifetime ISA (for those under 50) or otherwise a Workplace ISA. These should be accompanied by a default which would redirect the 3% to HMRC, triggered by non-payment of a bonus-eligible "quasi-employer" contribution. The latter could, to some degree, count as a tax-deductible business expense. Both auto-contributions and quasi-employer contributions could be ramped up in the style of AE, increasing in 1% annual increments, to 3% each by 2020, say.

5.3 *How about compulsion?*

Auto-contributions could be viewed as a particularly assertive form of auto-enrolment for the self-employed: perhaps the Government should bite the bullet and compel them to save? The issue probably boils down to one of presentation, and auto-contributions and quasi-employer contributions avoid the word "compulsion".

Matthew Taylor's review of the gig economy[35] stopped short of making specific recommendations on pensions savings for those working in the sector. Instead, the recommendation to "explore ways to improve pension provision amongst the self-employed, making the most of opportunities presented by digital platforms" passes the issue back to the AE Review.

In addition, it may be that following the Budget debacle, any tinkering with NI rates could be off the Government's immediate agenda. Such stasis provides an opportunity to consider some much more fundamental, difficult, questions. For example, should the tax framework cease differentiating between different forms of employment? Merging NI and Income Tax into a single Earnings Tax would hugely simplify the tax arena.[36] We could then revisit the question of all savings-related incentives in a clearer light.

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35 *Employment Practices in the Modern Economy*, 11 July 2017.

36 See *NICs: The end should be nigh*; Michael Johnson, CPS, 2014.

6. CONTRIBUTIONS

6.1 Too low

It is widely acknowledged that minimum contributions totalling 8% of band earnings is an insufficient final destination for AE. Modelling suggests that a typical 25 year old needs to save 15% to 18% of earnings to maintain their standard of living in retirement, from age 65, alongside a full State Pension.[37]

We should be aiming to at least double the 8% minimum, to 16% of band earnings, because of the increasing reliance on defined contribution (DC) provision, with its attendant investment, market timing and longevity risks. In addition, the retreating State Pension age (perhaps to accelerate following John Cridland's review) means that for people unable to work in their 60s, their savings will have to last for longer, before receipt of the State Pension.

But increasing the minimum contribution rate risks higher opt-out rates, and we do not fully understand the relationship between the two rates. It would also introduce tension between the Treasury and the DWP: "pushmi-pullyu government". Consumer spending would reduce, and with it, VAT receipts and broader economic activity, and the cost of tax relief would rise.

6.2 Attaining the Pensions Commission's 16%

There is a variety of "soft" tools available to help increase pensions contributions, including auto-escalation and "Save More Tomorrow", but they have not been widely adopted.[38]

(a) With band earnings retained[39]

Let us first consider adding 2% to each of the worker and employer minimum AE contribution rates (phased in as a 1% increase in each of 2019-20 and 2020-21, say), and replacing Income Tax relief and NICs rebates with Proposal 2's bonus structure, of 50% on the first £2,000 of post-tax contributions, and 25% on the next £6,000, paid irrespective of who contributes.

The total contribution rate would rise to 16.5% of band earnings on the first £2,000 of annual contributions (i.e. excluding the bonus), more than double AE's total minimum contribution rate[40] and exceeding the Pension Commission's 16% target contribution rate for median earners.[41] Bonuses would cease on annual contributions in excess of the annual allowance of £8,000, when the total amount saved would then be £10,500 (including £2,500 in bonuses): see Figure 2.

Only a tiny minority of people save for retirement anywhere near £8,000 on a regular annual basis. A ten year "roll-up" of unused annual allowances could be included to accommodate those who save larger sums on an irregular basis.

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[37] Association of Consulting Actuaries (ACA) response to the DWP's Review of Auto Enrolment, March 2017.

[38] Auto-escalation: contribution rates are increased on a fixed scale at pre-determined intervals. Save More Tomorrow: contribution rates are increased automatically with salaries, so people are giving up money they have never had. More than 60% of US companies offering DC pensions use SMT: as a result, some have seen savings rates quadruple.

[39] 2017-18 tax year band earnings: between £5,876 and £45,032 a year (as per the National Insurance contributions' Lower and Upper Earnings Limits, respectively).

[40] 4% + 2% from workers plus 3% + 2% from employers = 11%, plus a 50% incentive = 16.5%.

[41] *A New Pension Settlement for the Twenty-First Century*; the Second Report of the Pensions Commission, 2005.

(b) Using total earnings

Now let us consider using total earnings as the basis for calculating AE contributions. Using band earnings, a median earner would have total annual contributions of £2,434, plus £1,108 in bonuses, to total £3,542. This sum could be replicated, approximately, by increasing each of the worker and employer AE minimum contribution rates by 1%, to total 9%, calculated on total earnings. This, combined with Proposal 2's bonus structure, would take us to 13.5% of total earnings on the first £2,000 of contributions,[42] 11.25% on the next £6,000 and 9% thereafter (to a £40,000 earnings cap): see Figure 2.

6.3 Income in retirement

Let us consider the potential retirement incomes for people on gross annual median earnings, both for full-time employees (£28,000) and all employees (roughly £22,500), the latter to include part-time workers (typically low earners, who we want to include in the AE process).[43] Table 3 shows the results for the two different contributions frameworks; 16.5% of band earnings and 13.5% of total earnings, with retirement income being taken over 20 years and 25 years (to exhaust the pot).

Table 3's retirement incomes are substantial, more than doubling the incomes of those on a full State Pension (£8,297), to very respectable figures in the range of £16,600 to £21,500 per year. The benefit of the "total earnings" approach for those on lower incomes (using median earnings for all workers, £22,500) is apparent; their retirement incomes are typically 10.5% larger, whereas for full-time median earners (£28,000) the increase is 3%. These improvements do, of course, reflect the larger contributions being made.

6.4 Some perspective

(a) The cost of bonuses

In 2015-16, tax relief attracted contributions from individuals and employers of some £68 billion, in both workplace and personal pensions schemes: an average of £2,125 per member of the workforce.[46] Employers contributed a further

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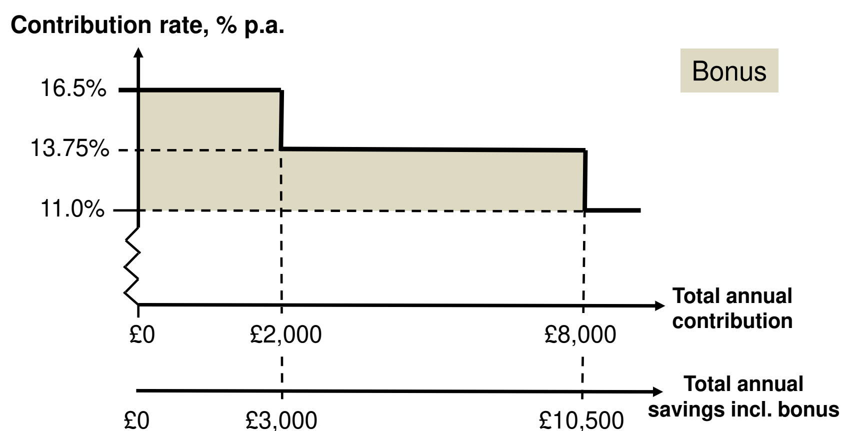
42 As 5% from employees + 4% from employers + 4.5% in 50% bonuses.

43 *Annual Survey of Hours and Earnings: 2016 provisional results*; ONS.

46 This figure is arrived at by considering the income distribution of 2015-16's total tax relief of £30.4 billion, as (roughly) 31%, 54% and 15% between the 20%, 40% and 45% Income Tax bands, respectively. The total UK workforce is 32 million (including the self-employed).

Figure 2: Total annual contributions: % rates and £ amounts



£25 to £30 billion in respect of DB scheme deficit repair, which did not attract tax relief.

However, not all workers saved: in 2015-16, 78% of all AE-eligible employees saved in workplace schemes (17.1 million people): let us assume that with the proposed, more redistributive, bonus structure, this were to rise to 85%.[47] If aggregate saving remained the same, the average would rise to £2,500 which, combined with the proposed bonus-based incentive, would cost £30.6 billion (be it via a band earnings or total earnings-based structure).[48] This is some £16.1 billion less than the 2015-16 cost of tax relief and NICs rebates. This is, of course, a very crude approach to assessing the potential cost of the bonus.

We also have to consider the cost of bonuses paid on savings made away from the workplace. In 2015-16, tax relief of £2.4 billion and £4.3 billion was paid on personal pensions contributions made by employees and employers, respectively.[49] The cost of bonuses on such saving is unlikely to exceed the cost of tax relief for several reasons:

- the aforementioned £30.6 billion of bonuses attributed to workplace saving consumes all of the proposed 50% bonus band. Consequently, all other contributions would only receive a 25% bonus (subject to the annual bonus cap), and given that it is often the same (wealthy) people saving in workplace and personal pensions vehicles, this will be instead of tax relief at 40% or 45%;
- reducing the annual allowance from £40,000 to £8,000 would also cut the total incentive amount going to higher rate and additional rate taxpayers; and
- aggregate personal pensions contributions are likely to diminish as AE contributions are ramped up.

In 2015-16, the self-employed claimed £700 million in tax relief, but they have already been accounted for within the aforementioned £30.6 billion of bonuses attributed to workplace saving.[50]

47 *Workplace Pension Participation and Savings Trends of Eligible Savers Official Statistics: 2006 to 2016;* DWP, 15 June 2017, and *Automatic enrolment: Declaration of compliance report, July 2012 to end May 2017;* The Pensions Regulator, June 2017.

48 As 32 million x 85% x (50% x £2,000) + (25% x £500).

49 *PEN6, Cost of Registered Pension Scheme Tax Relief; HMRC, February 2017.*

50 Ibid.

Table 3: Pot size after 40 years accumulation, and retirement income*

				Pot size	Retirement income, p.a.	
16.5% of band earnings	**Contributions**	**Bonus****	**Total**	**after 40 years**	**20 years**	**25 years**
Full-time median earnings	£2,434	£1,108	£3,542	£214,097	£12,837	£10,751
Median earnings, all workers	£1,829	£914	£2,743	£165,801	£9,941	£8,326
13.5% of total earnings						
Full-time median earnings	£2,520	£1,130	£3,650	£220,625	£13,228	£11,079
Median earnings, all workers	£2,025	£1,006	£3,031	£183,209	£10,985	£9,200

** Assuming 2% p.a. real asset growth in both accumulation and decumulation*

*** As 50% on first £2,000 contributions, then 25% on next £6,000*

(b) Bonus cost: conclusion
Detailed modelling of the proposed bonus structure is required. It would be a complex affair, requiring a number of significant assumptions for how people's saving behaviours would change in light of the new incentive structure.

Cost control would be achieved through a combination of the reduction in the annual allowance (effectively capping bonus payments at £2,500 per year), and the introduction of a 25% bonus on annual contributions above £2,000 (akin to 20% tax relief).

All in, the bonuses are unlikely to cost more than £35 billion per year, which would provide the Treasury with an annual saving of £11.1 billion, after scrapping tax relief and NICs rebates.

Proposal 10: The minimum AE contribution rates for employees and employers should both be raised by 1%, to total 9% of total earnings. Proposal 2's bonus structure would then take total contributions to 13.5% of total earnings on the first £2,000 of employee and/or employer contributions, and 11.25% on the next £6,000.

7. DECUMULATION

7.1 Auto-protection

Today, the state nudges and incentivises people to accumulate retirement savings, only to desert them at the start of decumulation. Automatic enrolment only operates during the accumulation period, up to private pension age (currently 55, rising to 57 in 2028). Thereafter, following the end of the annuitisation requirement ("freedom and choice"), there are no decumulation defaults.

Consequently many individuals, upon reaching the age of 55, are left to wallow in indecision when pondering the complexities of decumulation, vulnerable to their own irrational predilections (and scammers), playing chicken with their life expectancy and exposed to downside financial risks in later life, notably premature exhaustion of savings.

This could be addressed by introducing "auto-protection", as described in a recent paper.[51] It would have two distinct components:

(i) "auto-drawdown" at private pension age, in the form of an income drawdown default of, say, between 4% and 6% of pot assets, per annum. Providers should be encouraged to provide a low cost, diversified default fund for undrawn assets; economies of scale should help to deliver larger retirement incomes than otherwise; and

(ii) "auto-annuitisation" of residual pots, perhaps twenty years after private pension age. This would facilitate the collective hedging of individuals' exposure to the unquantifiable risks of longevity. It would also remove later-life exposure to investment markets risks and, through indexation, cost of living inflation.

Such as approach would accommodate the engaged because, to be clear, anyone would be free to opt out of one or both phases of auto-protection to pursue alternatives, consistent with 2015's liberalisation. There is no desire to prevent people from doing what they want with their own savings.

51 *Auto-protection: auto-drawdown at 55, auto-annuitisation at 80;* Michael Johnson, CPS, March 2017.

Proposal 11: "Auto-protection" should be introduced, with two distinct components:

(i) "auto-drawdown" at private pension age, in the form of an annual income drawdown default of between 4% and 6% of pot assets, paid monthly; and

(ii) "auto-annuitisation" of residual pots, perhaps twenty years after private pension age.

The introduction of auto-protection would address a major policy inconsistency, bringing the policy philosophy behind decumulation closer to that for the accumulation phase.

7.2 Product development: liberate NEST

The National Employment Savings Trust (NEST) has put considerable thought into products aimed at mass market decumulation. This is entirely sensible given its role in providing its members with a default accumulation fund, as part of automatic enrolment.

However, earlier this year the Government declared that it does not propose that NEST should begin to offer additional decumulation options at this time.[52] This is based upon reassurances received from the industry regarding its intention to innovate. Instead, it will keep the issue "under active review in light of market developments", i.e. to wait for market failure to become evident before enabling NEST to proceed.

There is little evidence to suggest that material developments will be forthcoming anytime soon. It is clear that the industry is struggling to develop simple, secure, low cost drawdown products, a challenge compounded by the public's unrealistic expectation for affordable products that combine flexibility with certainty.

NEST should be allowed to continue its research into mass market decumulation, including the operation of pilot schemes: this would help spur much-needed innovation, and competition, in the decumulation arena.[53]

Proposal 12: The AE Advisory Group should encourage the Government to reconsider its opposition to NEST developing mass market decumulation products, to include a collective drawdown capability to enable retirees to pool their longevity risk.

8. THE EMPLOYERS' PERSPECTIVE

Employers have welcomed the Lifetime ISA, recognising that it offers an opportunity to deliver a benefit to their younger employees that addresses their financial needs better than an inaccessible pension pot. They would also welcome the extension of the Lifetime ISA to include a Workplace ISA, all within the AE framework: the administrative and reputational burdens of sponsoring an occupational pension scheme could be consigned to history. Indeed, minimising the administrative burden on employers is an objective specifically referred to in the AE Advisory Group's Terms of Reference.

52 *NEST: Evolving for the Future; Government Response*, page 23; DWP, 2 March 2017.

53 See *Auto-protection* (CPS, 2017).

A survey by Willis Towers Watson (WTW) found that, within the next five years, 70% of large employers are considering offering a Lifetime ISA within their workplace benefits package. It also found that most employers are examining broader Workplace ISA offerings, which would cover all employees rather than just those eligible to save in a Lifetime ISA. WTW concluded that younger employees want greater choice and flexibility: adding Lifetime and Workplace ISAs to the benefits suite would resonate with their financial priorities, notably buying the first home, paying down debt, and building up general savings, in addition to saving for retirement.

A different survey found that 42% of employers plan to provide access to the Lifetime ISA through their reward packages.[54] This is perhaps in response to the expectation that at least some of their employees will save in a Lifetime ISA instead of a workplace pension.[55] This has prompted some employers to raise an obvious question: why are employees not allowed to save their AE contributions in a Lifetime ISA, with a Workplace ISA to accept the employer contributions?[56]

Given that employees are more likely to listen to their employer than either their pension provider or the Government, the latter should take note of what employers are saying about ISAs: they play a key role in nudging and encouraging people to save more.

9. CONCLUSION: MORE FLEXIBILITY REQUIRED

The AE Advisory Group cannot ignore the increasing number of people who are reluctant to lock up their capital by saving within the pensions framework. Indeed, there is an "epidemic of apathy around pensions",[57] especially amongst Generation Y, whose primary savings objective concerns home ownership.

Consequently, if automatic enrolment is to continue to raise the workplace saving participation rate and engagement, then the Lifetime ISA and a sister Workplace ISA should be introduced into the AE arena, not least to head off the risk of a rising opt-out rate.

54 WEALTH at work poll, conducted between August 2016 and March 2017.

55 26% according to Jelf Employee Benefits survey of private, public and third sector employers across England and Wales, November 2016.

56 See *Pensions News and Insights*; Xerox, August 2016.

57 Henry Stott's assessment, after Decision Technology's survey of auto-enrolled scheme members.

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