



St Clement's House, 27-28 Clement's Lane, London EC4N 7AE
Tel: +44(0)20 3207 9380 Fax: +44 (0)20 3207 9134 EMail: acahelp@aca.org.uk
Web: www.aca.org.uk



Survey of Smaller firms' pensions

Final Report of the ACA's Smaller Firms Pensions Survey

Conducted by the Association of Consulting Actuaries

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Chairman's Introduction: ACA Smaller Firms Pensions Survey

Pensions in smaller firms in many respects represent the 'Achilles heel' of UK provision. Despite initiatives by successive governments, still only around a third of smaller firms – those with 250 or fewer employees – provide any kind of scheme. And, as our biennial surveys of the sector have found since 1996, contribution levels into the dominant types of scheme have stuck at stubbornly low levels despite the increasing cost of building a sufficient pension as life-spans have stretched and economic conditions changed.

The latest government backed pension reforms – auto-enrolment and the launch of NEST – may well extend pension coverage 'into parts where it has not gone before', but immense challenges remain in achieving the end objective. That end objective needs to be maturing private pensions, when allied to State provision, that produce sufficient income so the vast majority of pensioners in the future have the prospect of a comfortable retirement. Pensions for many at near subsistence levels, still supported by extensive and costly means testing, should not be where we remain.

For those fortunate enough to be nearing retiring with defined benefit pensions in this smaller firms sector there still remains much greater certainty about the pension that will be delivered than for the greater number of employees in defined contribution schemes. Our survey found smaller defined benefit schemes are by and large better funded to meet their liabilities than two years ago with fewer than half in deficit. However, due to their cost and the forward risks involved, now close to nine out of ten are closed to new entrants and four out of ten to future accrual. Set against this, our survey has found savings by both employers and employees into defined contribution schemes generally have failed to increase in line with the cost of building a decent pension. Pension contributions into smaller firms' defined contribution schemes probably need to double on average to at least 15% of earnings if reasonable retirement incomes are to be achieved. Whilst understandable, it is concerning that the minimum levels of pension contributions under the auto-enrolment policy are very modest. If these levels become the norm, emerging pensions are likely to disappoint, feeding further disillusionment with pensions.

Whilst the country's dire economic position does not presently allow, it seems clear to me that if we are to encourage a much wider proportion of our people to save adequately for their retirement, we will need to make greater room for savings from individuals' disposable incomes. Employers too will need new rewards for boosting their pension contributions and greater freedom in pension design. Greater transparency and low-cost products will play a part in this, as will better consumer financial education and auto-enrolment – all of which is 'work in progress', with some areas more advanced than others, but more will be needed. A plan to provide new incentives to save, building up over a number of years as the economy recovers, is badly needed.

The smaller firms covered by this survey – so important to the UK economy in terms of employment and innovation but – where pension provision is endemically weak – seem particularly needful of financial incentives to kick start sufficient levels of pension saving.

Finally, I would like to thank all those firms that responded to the questionnaire for their help in providing the information for this latest survey report.

Stuart M Southall

Chairman

Association of Consulting Actuaries

Summary results: ACA Smaller Firms Pensions Survey

Survey background

The survey was conducted by the Association of Consulting Actuaries (ACA) in the summer of 2010 for online completion and was circulated to 12,000 of the UK's smaller firms with 250 or fewer employees, selected on a random basis. Responses were received from 404 firms. This survey focuses on general pension trends, including contribution levels by employers and members, and also views on auto-enrolment and NEST.

Executive Summary

Smaller firms and pensions

- 78% of firms responding to the survey employ 50 or fewer staff.
- The dominant types of scheme provided by respondents are Group Personal Pensions, Stakeholder and trust based defined contribution schemes. Where final salary schemes are provided, 86% are closed to new entrants and 41% also to future accrual.
- Across most types of schemes, membership participation is slightly below 60% of employees, with Stakeholder pension participation lowest at, on average, 38% of eligible employees.
- Firms say the principal reasons why employees do not join existing schemes are 'cost' (84%), a 'preference to spend' (72%) and 'disillusionment with pensions' (69%).
- Firms not providing pensions say they do not principally because of 'cost' (96%), 'economic conditions in their sector' (82%) and 'insufficient competitive pressures' (53%).
- A quarter of firms (24%) are reviewing their pension arrangements in the year ahead.

Pension spend and contributions

- 43% of firms do not have a target for their pension costs, but 29% are targeting employer pension costs of 4% of payroll or more.
- 21% of firms are looking to decrease their pension spend, balanced by 14% aiming to increase spend.
- Firms responding to the survey report average combined employer and employee contributions into defined contribution schemes ranging between 7.6% and 9.3% of earnings. Average combined contributions into defined benefit schemes are 24% of earnings.
- The average ongoing funding level of defined benefit schemes responding to the survey was 82% expressed as a percentage of liabilities. Of those 46% of schemes in deficit, a third said their recovery plan was in excess of ten years.

Investment

- Over the last year only 8% of schemes said they had changed to a greater proportion of investments in bonds as opposed to equities – a big reduction in the trend reported two years ago.
- 71% of defined contribution schemes offer a default investment fund, and 62% offer only one fund manager.
- One in six (16%) of firms assist retirees by helping them with their open market option prior to purchasing an annuity by providing them with a range of quotations.

Pension reform

- 73% of firms say they support an increase in the State Pension Age to age 67 being completed by 2026.
- 65% of firms running defined benefit schemes say that the Government should enact legislation enabling schemes to index pensions in line with CPI if they so wish in the future.
- 67% of firms say they want a statutory override that would enable them to adjust scheme pension age automatically as life-spans extend.
- 54% of smaller employers support the principle of auto-enrolment into workplace pensions. Support for NEST is mixed. 43% of smaller employers agree with it, while the remainder are split between those who would prefer commercial provision (11%) and those who disagree with the concept altogether (46%).
- Only 1 in 5 smaller firms (21%) has as yet budgeted for the cost of auto-enrolment. However, 55% say the introduction of auto-enrolment and NEST will 'significantly' add to their business costs.
- 62% of smaller firms are likely to auto-enrol current 'non joiners' into existing schemes.
- However, 20% say they will close their existing scheme and auto-enrol all employees into NEST. Around a quarter (24%) of smaller firms say they will auto-enrol employees into a new firm's scheme, and a fifth will restrict entry into an existing scheme placing the balance of employees in NEST, or will use NEST as a foundation scheme.
- Smaller firms expect an employee 'opt-out' rate after auto-enrolment of, on average, 35%.
- 29% of smaller firms are 'likely' or 'highly likely' to consider levelling-down to mitigate the cost of auto-enrolling additional employees.
- 66% say that employers with one employee (and 50% with fewer than five employees) should be exempt from auto-enrolment – *a view rejected by the recent review of auto-enrolment*.
- 53% say that the requirement to re-enrol 'opters-out' every three years should be removed – *a view rejected by the recent review of auto-enrolment*.
- 61% say employees with less than 3 months' service should not be auto-enrolled – *a view now being taken up by Government*.
- 39% say auto-enrolment should await legislation that allows greater freedom in pension design.

Smaller firms' place in the UK economy

The smaller firms sector – firms employing 250 or fewer employees – is the largest part of the UK private sector economy in terms of employment. The sector's 1.2 million smaller firms employ over half of the UK's private sector employees (60%) and generate a half of all private sector turnover (49%), amounting to some £1,589 billion per year. They make up over 99% of all UK private sector enterprises – there are just over 6,000 UK private sector enterprises that now employ 250 or more employees.

Whilst figures vary from year to year, these 1.2 million organisations that employ at least 1 employee, are made up of companies (747,000), but also employees of partnerships (170,000) and of sole proprietors (302,000). In a typical year, the number of employing organisations ceasing and forming can be around 30 - 40,000. Only a minority of these employers – around a third – provide any form of workplace pension and are a key target for the extension of coverage under the Government's pension reforms.

Following the Government's decision to press ahead with auto-enrolment of employees into pensions in firms with one or more employees, the challenge to both the Pensions Regulator and NEST will be to capture data on around 1.2 million smaller firms (the majority with fewer than 5 employees). This will encompass being able to cope with the dynamic changes in business numbers each year, the movements of employees from firm to firm and changes in opt out decisions, and – of course – pension investment decisions and individual employees' changes thereto. This will be an extremely challenging task with an exacting timetable under the staging arrangements published.

Figure 1: UK private sector: number of enterprises and employment by size of firms

UK Smaller private sector firms	Number of enterprises	Employees (thousands)	Average number of employees per enterprise
No employees (see note below)	3,613,975	535	-
1 employee only	189,120	189	1
2-4 employees	606,485	1,585	3
5-49 employees	391,670	4,625	12
50-249 employees	26,905	2,617	97
Total: smaller firms (1-249 employees)	1,214,180	9,016	7

(Source: Dept for Business Innovation and Skills, Enterprise Directorate Analytical Unit, 2009 figures, published 13 October 2010.

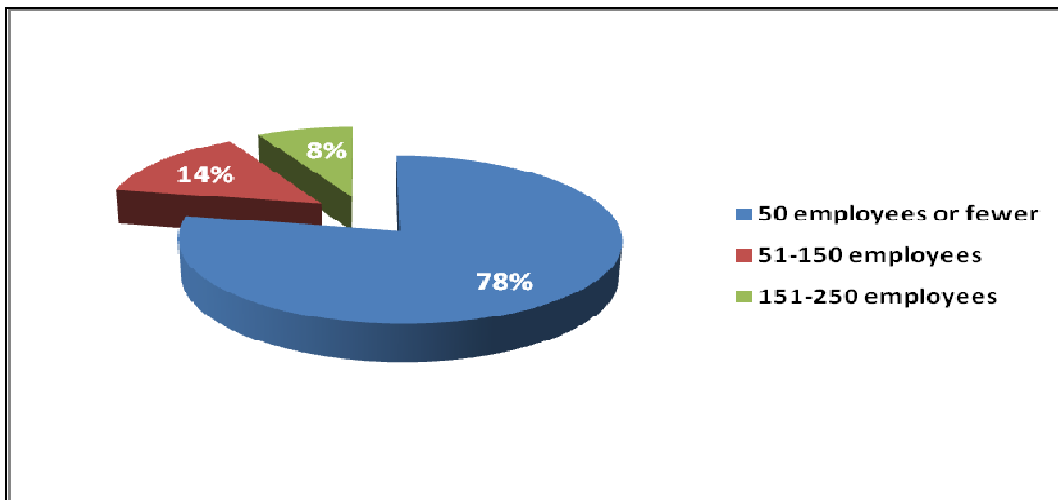
Note: 'No employees' comprises sole proprietorships and partnerships comprising only the self-employed owner-manager and companies comprising only an employee director)

Smaller firms responding to the survey: by employee numbers

Over three-quarters of the smaller firms responding to this survey employ 50 or fewer staff, with the balance of respondents employing between 51 and 250 employees. This sample does not represent a 'mirror image' of the UK's smaller firms sector. If it did, around 98% of the sample would be drawn from firms with 50 or fewer employees¹.

Equally, with only 12% of respondents indicating they do not run a pension scheme, the sample is not typical of the sector as a whole in that it over represents the proportion of smaller firms offering pension arrangements. **Over 65% of the UK's smaller firms provide no workplace pensions albeit it is estimated around 5% make contributions into employees' personal pensions².**

Figure 2: Smaller firms - organisations responding to the survey



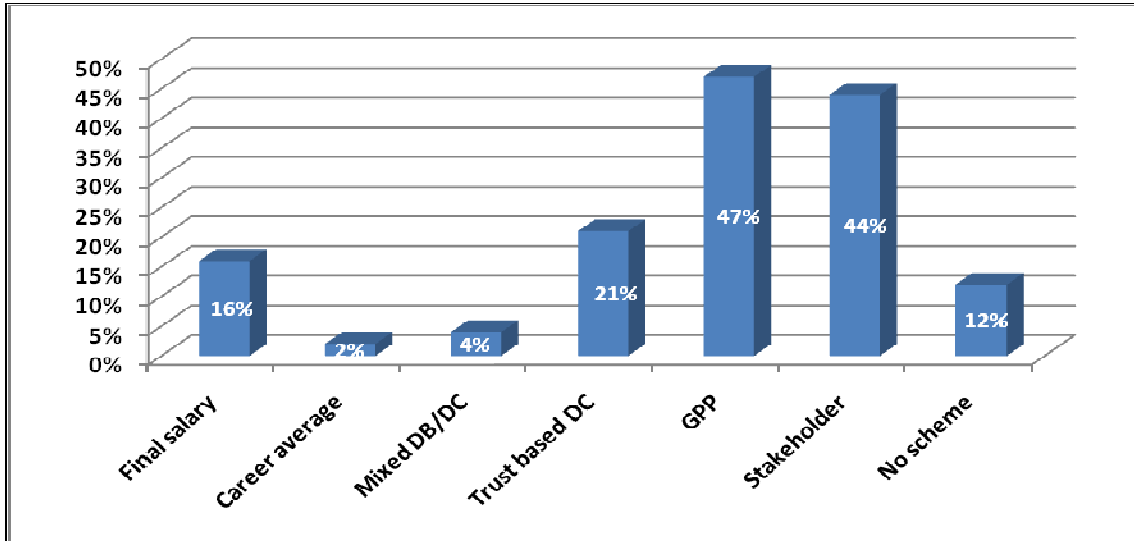
¹ Source: ONS Inter-Departmental Business Register 2009

² Source: DWP Research Report *Employers' attitudes and likely reactions to workplace pension reforms 2009*

Types of schemes run by smaller firms responding to the survey

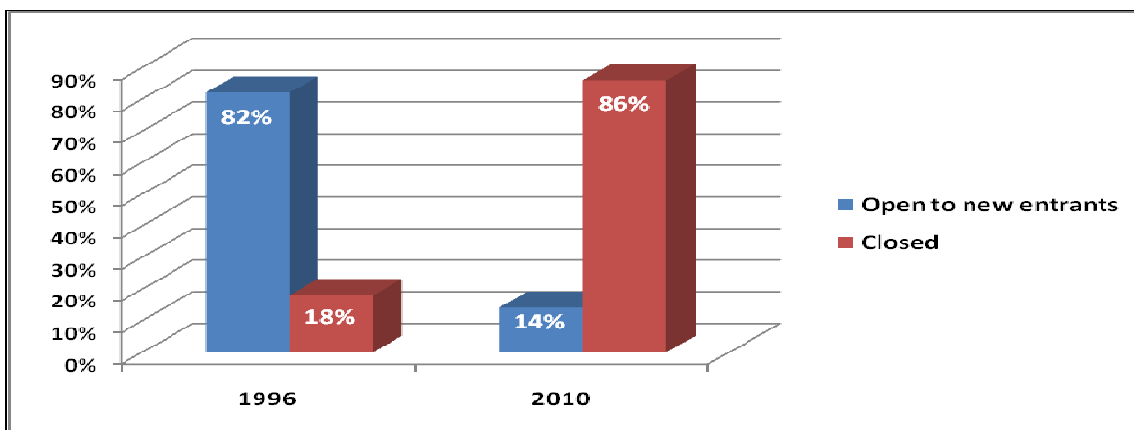
The dominant types of scheme being run by today's smaller firms are defined contribution in nature, with Group Personal Pension Schemes (GPPs) and Stakeholder schemes the most common.

Figure 3: Smaller firms - schemes in survey: by type



Of the final salary schemes provided by these smaller employers, 86% are reported closed to new entrants and, of these, 41% are now also closed to future accrual by existing employees. Increasingly, the Government and recent reports have referred to the decline in defined benefit schemes 'starting in the 1960s', and this seems to suggest a steady decline therefrom. In fact, the major wave of closures is post the mid 1990s. **When this series of biennial surveys into pension scheme trends in smaller firms began in 1996, 82% of defined benefit schemes in smaller firms were open – a situation that has reversed in just 14 years.**

Figure 4: Smaller Firms – defined benefit scheme closures 1996 – 2010



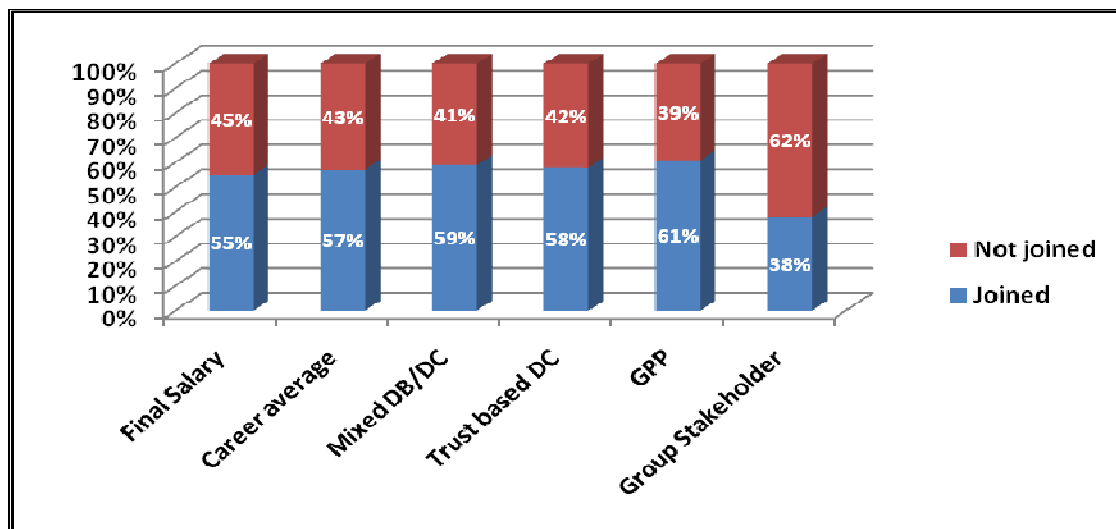
Reflecting a move away from trust based in favour of contract based defined contribution schemes, 11% of trust based schemes are also reported as closed to new entrants, with the majority also closed to new contributions from existing employees. The majority of firms reporting such a closure now offer either GPPs or Stakeholder schemes.

Average scheme membership by eligible employees

Of those eligible to join workplace pension schemes in these smaller firms, average participation rates vary between 38% in Stakeholder schemes (27% of Stakeholders reported 'nil' members) through to 61% in Group Personal Pensions (GPPs). Of those firms responding to the survey just 6% already auto-enrol at least some employees into a scheme.

With generally over 40% of employees not in membership of workplace schemes (with this rising to 100% for the 12% of respondents who provide no scheme), there are clear cost implications for most smaller firms when they have to auto-enrol employees into either existing 'qualifying' schemes or into NEST under the Government's staging and phasing schedule between 2014 and 2016. The degree of those cost increases will hinge upon whether any scheme is offered at present, the level of opt-outs and the levels of employer contributions into the future for existing and new members.

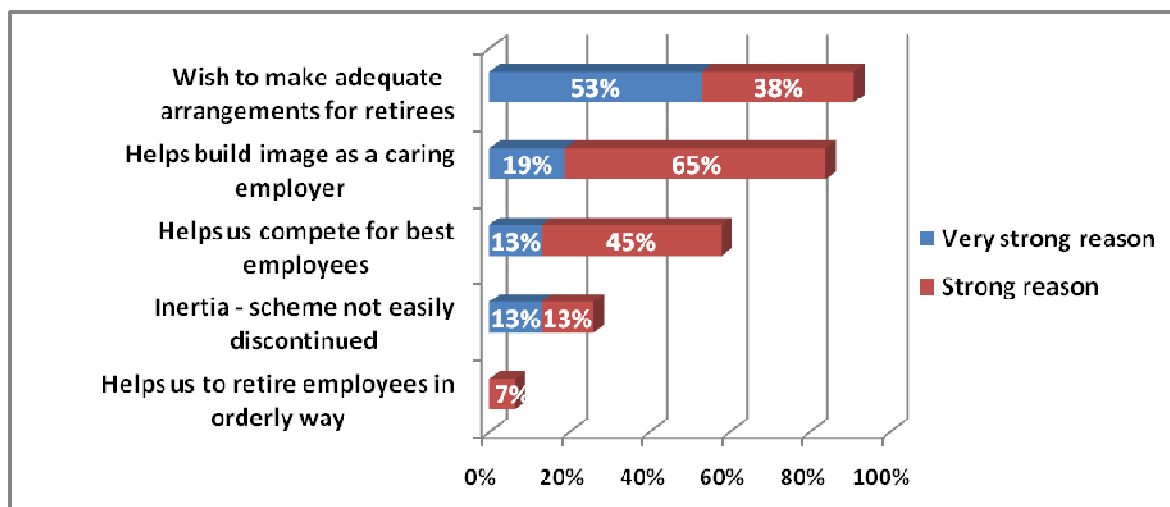
Figure 5: Smaller firms - scheme membership



Why are so many employees in smaller firms not in pension schemes?

It is encouraging within this sample that some 9 out of 10 these smaller firms wish to make adequate pension arrangements for their retirees, with a majority also seeing the good sense in providing a scheme to convey a positive image of their business to both existing and prospective employees. **Surprisingly few – just 7% – see a scheme as a means of retiring older employees in an orderly way**, which may explain why only 12% feel that offering a scheme in the future will be helpful in encouraging older employees to retire once the default retirement age is removed later in 2011.

Figure 6: Smaller firms – why do they offer pension schemes?



However, in so far as this survey focuses primarily on smaller firms who provide a pension arrangement, it needs to be remembered that two-thirds of smaller firms currently offer no pension at all. We explore later why this is the case.

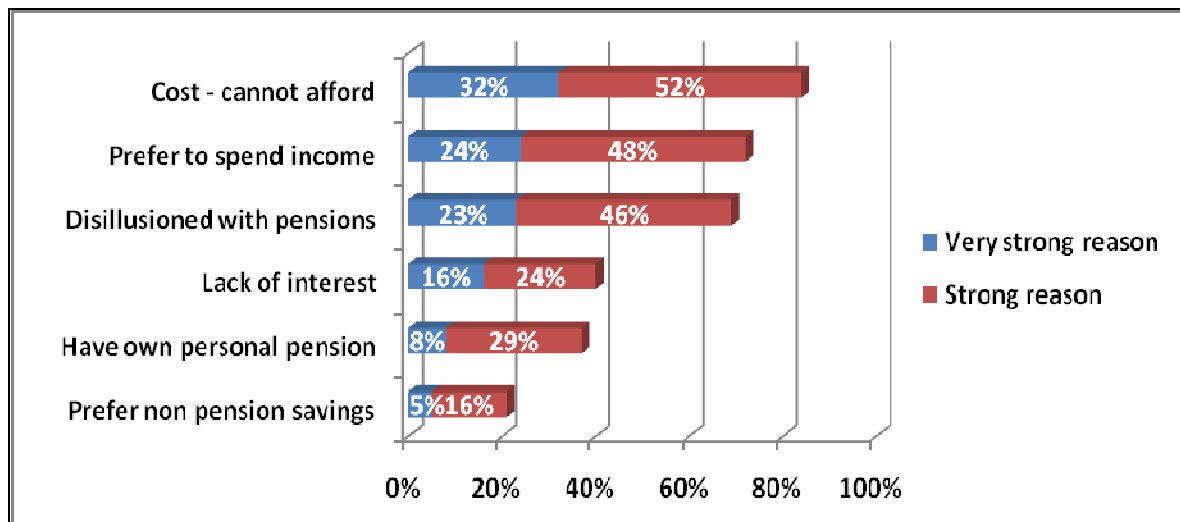
Firms are very clear on why they feel so many employees have not joined existing workplace pension schemes. 84% of firms say employees ‘cannot afford the cost’ (although, 72% also say employees prefer to ‘spend their income’). Whilst amongst lower income groups, ONS figures suggest there is little or no room for private savings given current spending patterns and credit commitments, it is less clear this is the case for those around and above average earnings.

A worrying finding is that 69% of firms believe employees are ‘disillusioned with pensions’, no doubt in the wake of events over the last decade or so. Disappointing growth in defined contribution pension pots as investment returns have reduced, lower annuity rates and, for some, experiences of scheme closures and levelling-down will all have played a part in this situation. The prospect of later retirement ages may also be deterring younger employees from pension saving – other earlier spending priorities appear much more relevant. This is a situation which may have some way to run with many young employees in their 20s and 30s likely to have much larger post-university debts to clear in the years after 2012.

These results underscore that whilst auto-enrolment into workplace pension schemes may indeed increase the numbers making pension savings from 2012, there remain huge financial and communication

challenges to be addressed if we are not to see the emergence of high opt-out rates. This is particularly the case in this smaller firms sector where pay, benefits and resources for communication generally tend to be lower than in larger private and public sector organisations.

Figure 7: Smaller firms with pension schemes – why do you think employees do not join?



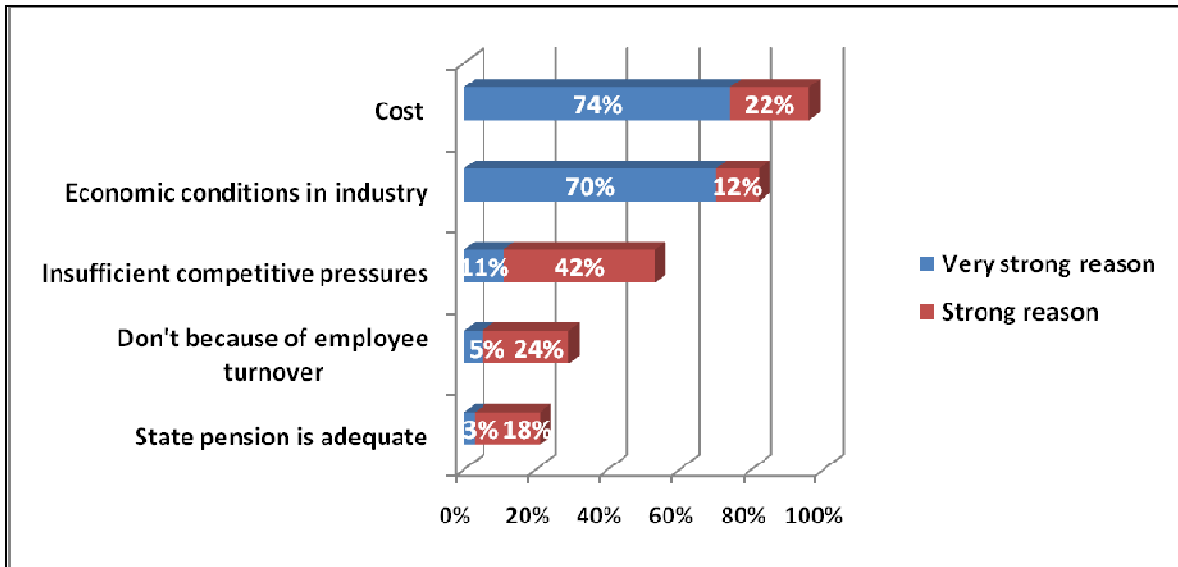
Why do so many smaller firms not offer pension arrangements?

Almost all (96%) of smaller firms responding to the survey, who do not offer pension schemes, say this is down to ‘cost’ – a view which they say is buoyed at present by economic conditions in their respective industries.

Also, over half say that competitive pressures in their work sectors do not require that they provide pension arrangements, with three in ten saying the high levels of staff turnover they encounter providing a further disincentive.

Somewhat surprisingly, one in five firms says that they feel the State pension is ‘adequate’ to meet the retirement needs of employees. Given the level of State pensions in the UK, this is a difficult response to justify unless respondents believe means-tested State benefits should continue to be a major source of additional income for many in retirement.

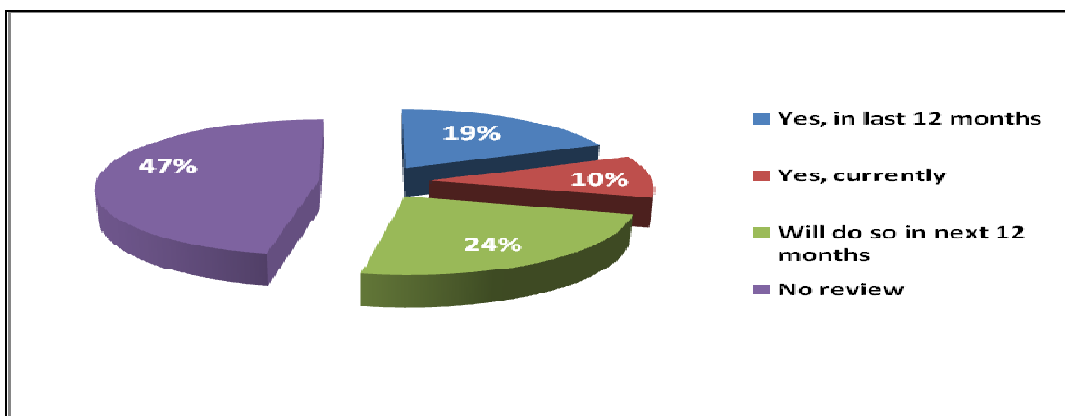
Figure 8: Smaller firms with no pension scheme or employer contribution – why is this?



Scheme reviews

A majority of smaller employers will have reviewed their pension arrangements over a two year window. It maybe that this reflects the stream of regulatory measures impacting on existing arrangements in recent years. However, given the numbers looking to undertake reviews in the next 12 months (24%), it may be a sign that the 2012 reforms are beginning to be noticed, with early actions now being considered. Although smaller firms have more time to consider how they should react to the reforms, it may well be that the staging and phasing message has not been fully appreciated, with many of these smaller businesses registering the '2012' date as one they must act by.

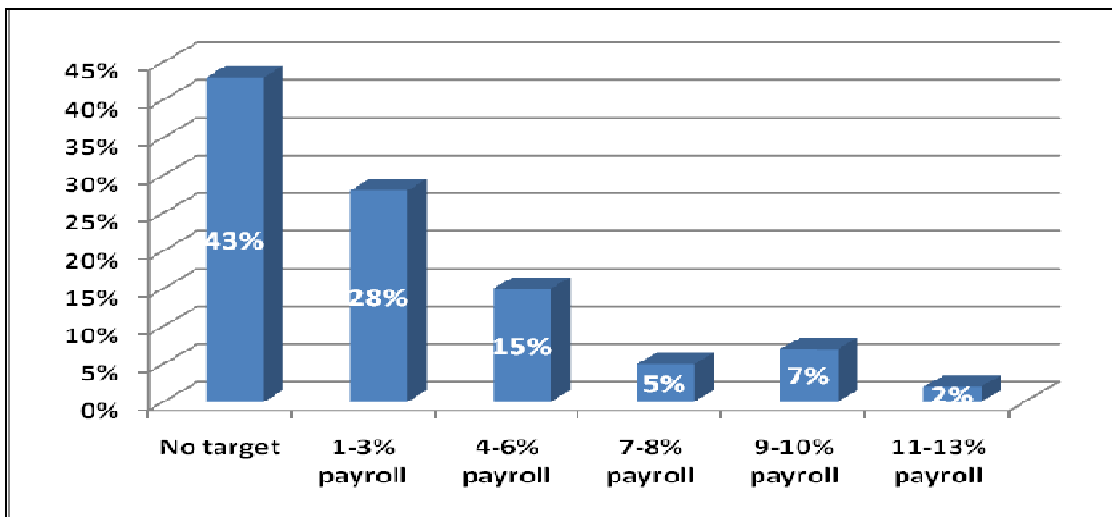
Figure 9: Smaller firms: have you or are you about to review your pension arrangements?



Targets for pension costs

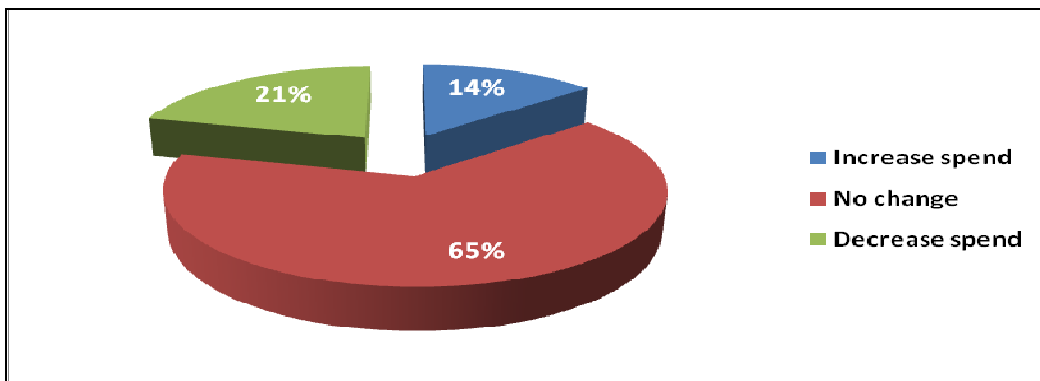
Whilst four out of ten smaller firms do not have a target for their pension costs, it is encouraging that 3 in 10 are targeting employer pension costs of 4% of payroll or more (i.e. broadly in excess of the minimum employer contribution levels that will come into full force from October 2017 for employees in membership of 'qualifying' company schemes or NEST). The concern is that those saying 'no target' is made up of those firms who presently make no workplace provision or where employer contributions are presently around the minimum of 3% of earnings applying from late-2017.

Figure 10: Smaller firms: do you have a target as to what your business will spend on pensions as a percentage of payroll?



However, given the difficult economic times many businesses are experiencing, it is relatively 'good news' that those looking to reduce pension spend (21%) only modestly outnumber those looking to increase spend (14%), with the majority holding to their current spend on pensions. Whether the developing economic situation in 2011/12 may cause more businesses to 'think twice' about their budgets, including pension costs, remains to be seen.

Figure 11: Smaller firms: overall, is your business trying to increase or decrease its' spend on pensions?



Pension contribution levels

Employer contributions into defined contribution schemes across these smaller employers are averaging between 4 to 6% of earnings, with employee contributions hovering between 3% and 4% of earnings. Contribution levels reflect both the type of arrangement provided and the size of employer. **In the main, trust based defined contribution schemes are attracting higher levels of contributions than both GPPs and Stakeholder schemes.** Also, both employer and employee contributions in firms with over 150 employees tend to be higher than in firms with fewer employees.

What these figures indicate is that as auto-enrolment (and NEST) move ahead, there is limited scope in most smaller firms for levelling-down existing pension contributions to mitigate the potential cost of enrolling additional employees into schemes. As we reported in a survey of larger organisations³ conducted in the summer of 2010, levelling-down is much more likely to be a feature in larger organisations where current employer contribution levels tend to be much higher. **That said, there is scope in the average contribution rates reported for levelling-down in a swathe of smaller firms to defray the cost of additional employees joining ‘qualifying’ schemes from 2014.**

Whether this occurs is likely to depend on estimates of how many employees will opt-out (estimates, at present, are much higher amongst these smaller firms than has been reported by larger employers, see *page 20*).

What may also hold down costs and levelling-down of existing members’ benefits is if current ‘non members’ are enrolled into schemes where employer contributions are lower than for existing members. Such a two-tier approach to provision may seem to have negative HR implications and may prove difficult to deliver in practice, but our findings (see *Figure 20, page 22*) and the DWP’s 2009 research seems to suggest this is an approach being considered by a wide range of employers⁴.

Certainly, the implementation of auto-enrolment/NEST reforms may well accelerate the closure of those remaining open defined benefit schemes in the sector (where average employer contributions are presently close to 18% of earnings with total contributions around 24%). Whilst these levels of average contributions are marginally down on two years ago, continuing funding deficits in some schemes allied to factors such as continuing improvements in life-spans and weaker investment returns, means the much more affordable 11% (employer) + 4% (employee) contributions we found into defined benefit schemes in our 1996 survey are levels of a bygone age.

³ ACA Survey Report, *Auto-enrolment and NEST* in larger organisations, published 31 August 2010 (see: www.aca.org.uk – publications)

⁴ Source: DWP Research Report *Employers’ attitudes and likely reactions to workplace pension reforms 2009*

Figure 12: Smaller firms: 2010 defined contribution levels (as a percentage of earnings) broken down by firms' sizes (2008 'All' figures in brackets are weighted to 2010 distribution of responses by size of firms)

Average employer contributions	1-50 employees	51-150 employees	151-250 employees	All
Trust based defined contribution	4.8% (4.5%)	5.5% (5.2%)	6.6% (6.0%)	5.5% (4.7%)
Group Personal Pension	3.7% (3.9%)	4.9% (4.7%)	5.5% (5.5%)	4.2% (4.1%)
Stakeholder scheme	4.1% (4.0%)*	4.8% (4.5%)*	5.2% (5.0%)*	4.3% (4.2%)*

Average employee contributions	1-50 employees	51-150 employees	151-250 employees	All
Trust based contribution	3.1% (3.2%)	4.2% (4.0%)	4.6% (4.7%)	3.8% (3.4%)
Group Personal Pension	3.2% (3.0%)	3.6% (4.1%)	4.1% (4.3%)	3.4% (3.3%)
Stakeholder scheme	3.6% (3.0%)	3.8% (3.2%)	4.3% (3.8%)	3.7% (3.1%)

Average combined contributions	1-50 employees	51-150 employees	151-250 employees	All
Trust based contribution	7.9% (7.7%)	9.7% (9.2%)	11.2% (10.7%)	9.3% (8.1%)
Group Personal Pension	6.9% (6.9%)	8.5% (8.8%)	9.6% (9.8%)	7.6% (7.4%)
Stakeholder scheme	7.7% (7.0%)*	8.6% (7.7%)*	9.5% (8.8%)*	8.0% (7.3%)*

Note: *Stakeholder figures exclude 27% of schemes with 'nil' employer contributions

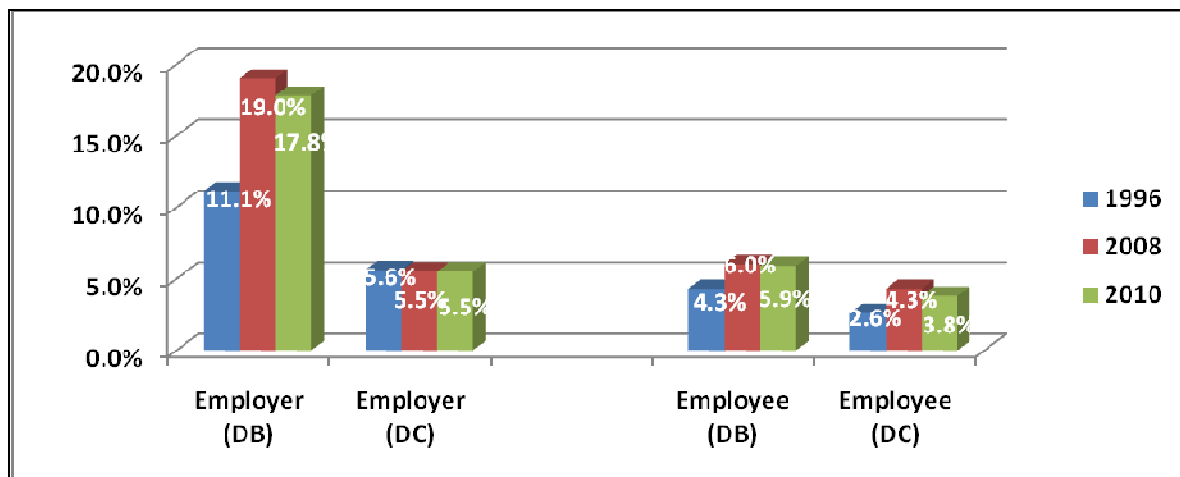
However, higher defined benefit pension scheme contributions do reflect the increasing cost of delivering pensions as life-spans extend and economic and regulatory factors change. **The worrying aspect is that both employer and employee contributions into defined contribution arrangements run by smaller firms have remained much 'the same' over the period since 1996 (see Figure 13, page 15) and, certainly, have not moved upwards so as to maintain the real value of defined contribution pension outcomes over the years. Over the last 5 years, fewer than 10% of employers and 5% of employees report increased contributions into defined contribution schemes/plans.** Where contributions from employers and employees have advanced most over the last 2 years – into trust based schemes – is where there have also been most scheme closures. A recent TPR paper⁵ found there has been a 15% reduction in trust-based defined contribution scheme numbers across all employers in the last year alone.

⁵ DC Trust: A presentation of scheme return data, published by the Pensions Regulator on 28 October 2010

With today's annuities delivering typically 70% less pension than in 1996 for equivalent 'pot' sizes, **the need for increases in pension contributions (or other savings) is absolutely essential if we are not to see in the future many old people living for an increasing number of years in very reduced circumstances in retirement.** For some, and alarmingly this may be a very sizeable and growing group given current economic circumstances, pension saving will remain a distant prospect. Clearing costly debt and sheer 'wherewithal' may rightly prevent many from looking to pension savings now and, unfortunately, long into the future.

However, beyond this group, persuading the wider public to think again about their spending and savings priorities is not really even 'work-in-progress' in public policy terms, but this is an essential next step if we are to reduce the proportion of those living on low incomes in later life.

Figure 13: Smaller firms – Comparison of employer and employee pension contributions (as a percentage of earnings) 1996 – 2008/2010



Defined Benefit scheme funding and recovery plans

Whilst the number of smaller employers offering defined benefit schemes – and certainly schemes open to new entrants and future accrual – has diminished markedly over the last 15 years, **it is encouraging and perhaps surprising that fewer than half (46%) of the firms running such schemes in this sample have been advised by the Scheme Actuary that their scheme is in deficit.**

This may be as a result of extra employer and employee contributions in recent years. And some 37% of these schemes have made additional contributions over the last five years to improve their funding position. As a result, **the average ongoing funding level of the schemes covered by the survey, expressed as a percentage of liabilities, is 82%** (two years ago, the survey reported a 75% average funding level). This position seems to endorse the *Purple Book* findings of the TPR/PPF that generally smaller schemes are better funded than larger schemes⁶.

⁶ 2010 *Purple Book*, DB Pensions Universe Risk Profile, page 42.

However, for those schemes that remain in deficit, the survey found a general lengthening of recovery periods as compared to two years ago, with a third now being ten years or more, compared to just over a fifth in 2008. Whilst the defined benefit sample is small, this seems to suggest a generally improving funding position amongst smaller schemes, clouded by a minority of schemes run by firms where economic circumstances may be stretching resources and thereby extending recovery plans.

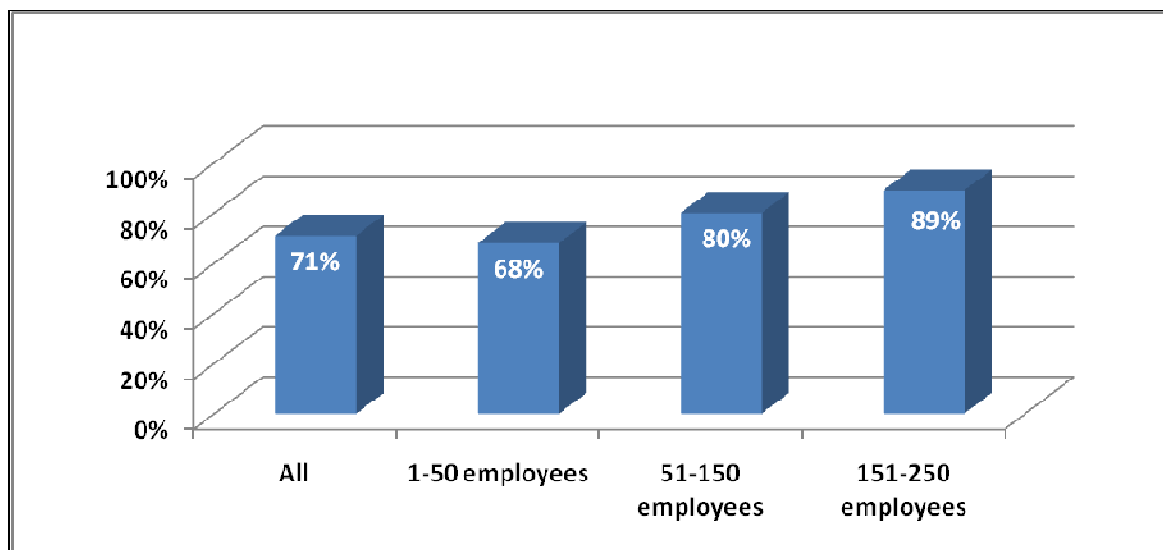
Investment

Defined benefit schemes: strikingly, over the last year only 8% of schemes said they had changed to a greater proportion of investments in bonds as opposed to equities (contrasting with 2008, when three-quarters reported such a shift). 10% of schemes have however changed the balance of their investments to incorporate or reduce other investments such as commodities and property, or to change the proportions held in UK and overseas equities. **On average, across the sample, 54% of scheme assets are passively managed** (an increase of 7 points on the situation found in 2008).

Defined contribution schemes: overall 71% of schemes offer a default fund, with this most prevalent amongst the schemes run by larger employers in the sector. Three-quarters said their default strategy offers a lifestyle fund. A quarter of the schemes (24%) have in excess of twenty-five fund options, but 62% offer only one fund manager.

One in six employers (16%) assist retirees by helping them with their open market option prior to purchasing an annuity by providing them with a range of quotations. The balance leave the quotations and decision to the individual.

Figure 14: Smaller firms – default funds are offered by majority of defined contribution schemes

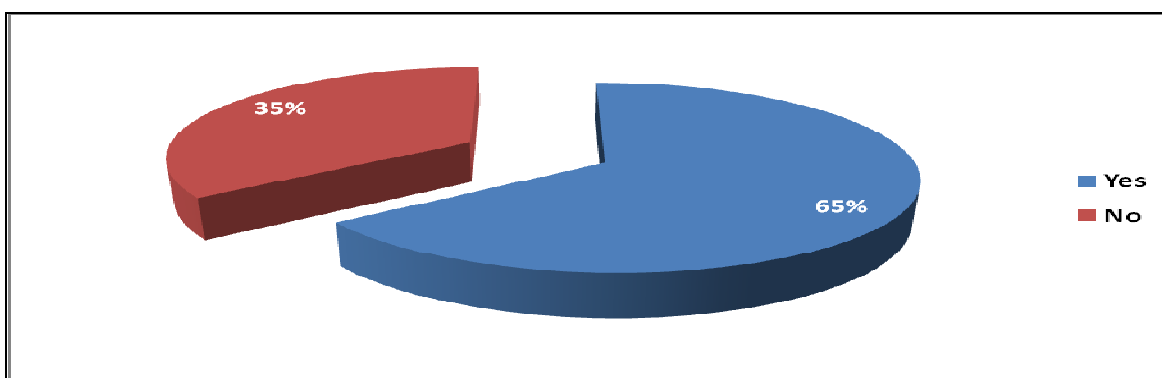


Pension reform issues

Defined Benefit pension indexation: reflecting the Government’s announcement in the summer that generally State benefits and pensions – including public sector pensions – should henceforth be indexed in line with the CPI rather than RPI, the survey asked smaller firms what their views were in respect of private schemes. **Two-thirds of the respondents running defined benefit schemes say that the Government should enact overriding legislation enabling schemes to index pensions in line with CPI if they so wish to in the future.**

This is probably understandable as, it appears, many schemes may have ‘hard wired’ RPI into deeds (estimates suggest that this might be the situation in some 60% of schemes). This is an issue that is now being consulted upon by Government and is one where there are both legal and practical implications that may work against the general application of CPI in the private sector (and maybe in some areas of the public sector too). An uneven application of CPI between private and public sectors and within sectors would be an unfortunate outcome and – again – this might prompt further decisions to close off schemes where RPI has to be retained or certainly may prompt attempts by employers to amend scheme rules as a trade-off for strengthening scheme funding positions.

Figure 15: Smaller firms running defined benefit schemes – should the government enact overriding legislation that would enable all schemes to index pensions in line with CPI if they so wished?



State and scheme pension age: 79% of smaller firms said they supported the increase in the State Pension Age (SPA) to age 66 sooner than 2026 (which, shortly after the survey was conducted, was confirmed as Government policy). However, reflecting the recognition that life-spans are generally improving by over 2 years every decade, the survey found firms supported further increases in the SPA in the relative near-term. **Three-quarters (73%) said the move to age 67 should be completed by 2026, with close to a half favouring a date as early as 2020.** There was less commonality of opinion about when the move to age 68 should take place, but 56% supported a timeframe between 2026 and 2036.

Only a few schemes (5%) said they had increased their scheme pension age over the last five years, but **two-thirds (67%) said they wanted a statutory override that would enable them to adjust scheme pension age automatically as life-spans extend**, provided reasonable notice is given to members, with the majority saying this should fall in line with changes in the SPA. **It is noteworthy that by 2020, half of the firms sampled expected their firm’s normal retirement age would be 67 or 68, with a fifth expecting age 70 or beyond.**

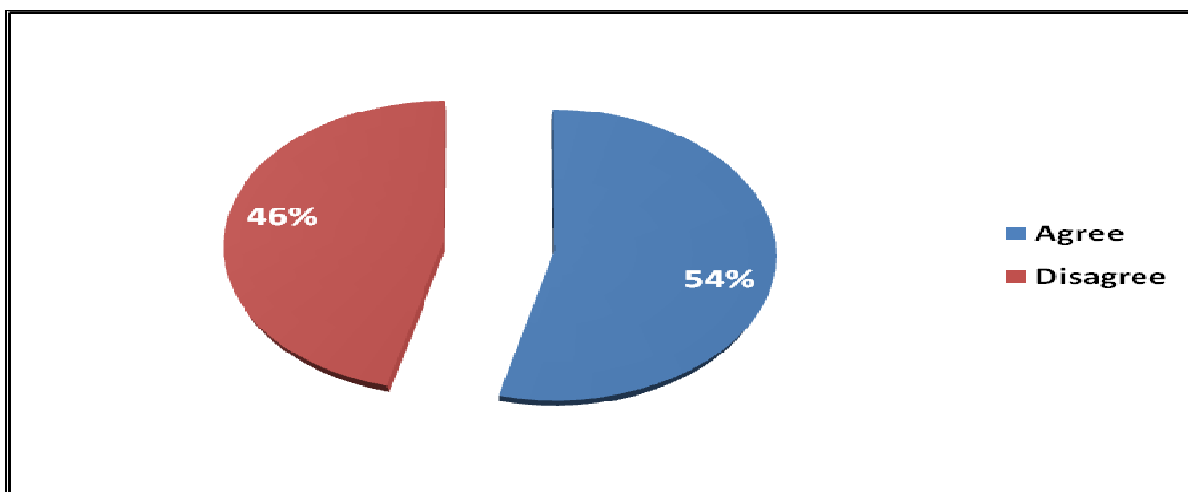
Auto-enrolment and NEST

Smaller firms views on auto-enrolment and NEST were highlighted in our initial report on this survey. The commentary has however been updated to reflect the Coalition Government's decision in late October to press ahead with the reforms, albeit with some changes in the detail, following on from the report by the independent auto-enrolment reviewers commissioned by the government after the May general election.

Do you broadly agree with there being a new employer duty to auto-enrol most employees into a workplace pension scheme with certain minimum standards?

A majority of smaller firms (54%) said they supported the new employer duty to auto-enrol into a qualifying scheme. This is perhaps higher than might be expected given the extra outlay involved in auto-enrolment in a sector where current pension scheme participation rates are low. However, as we note elsewhere in the report, this response may to some degree reflect a generally pessimistic view by firms in terms of how many employees will continue in scheme membership following auto-enrolment.

Figure 16: Smaller firms - support for auto-enrolment



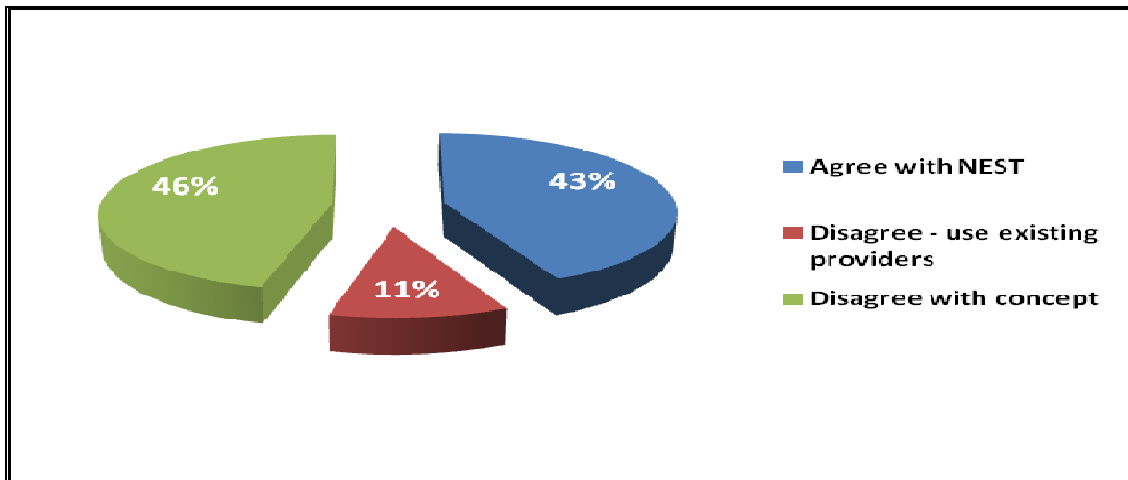
Do you broadly agree with there being a new national scheme (NEST) set up that employers must auto-enrol most employees into if they do not offer access to a workplace pension scheme of a minimum standard?

A sizeable minority (43%) of smaller firms said they are supportive of NEST (the National Employment Savings Trust) as a fall back arrangement where employers fail to offer their own 'qualifying' workplace pension scheme into which employees are auto-enrolled that meet the minimum standards set by Government.

Of those that are opposed to NEST, 46% disagree with the concept – in the main these are those who also oppose the auto-enrolment approach. A further 11% oppose NEST on the basis that they feel existing commercial providers should be able to meet the market's needs, presumably on the basis that this would avoid the need to establish a new centrally organised administration at a time when the Government's

financial resources are already over-stretched (and given the impact that these costs are having on charges to members over the foreseeable future). The difficulty with this view is that commercial providers have shown little enthusiasm to date for such an approach, although a number of providers more recently have outlined vehicles for employers to consider as an alternative to NEST.

Figure 17: Smaller firms - attitudes towards NEST



Depending on the number of employees in your firm, you will be required to auto-enrol all 'eligible jobholders' into a 'qualifying workplace pension scheme' (QWPS) - a firm's scheme or NEST - between 2012 and 2016. Are you aware of the date when your firm must auto-enrol 'eligible jobholders' into a qualifying scheme?

Some 54% of smaller firms say they are aware of the date between March 2014 and February 2016 when they must auto-enrol eligible jobholders into either a 'qualifying' existing or new firm's scheme or NEST.

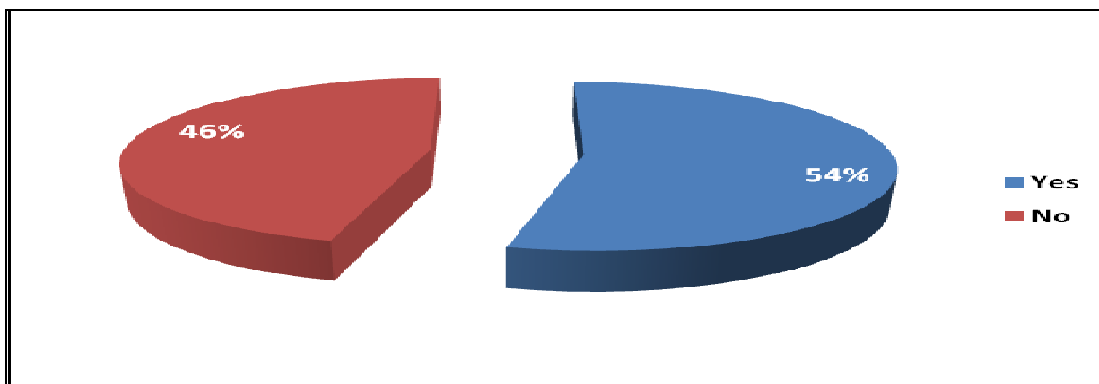
In October 2012, the largest employers begin auto-enrolment with perhaps some starting earlier on a voluntary basis. The vast majority of firms responding to this survey will have to auto-enrol from March 2014 (by which time all employers with over 90 employees will have had to comply) onwards through to 2016. Those remaining firms offering auto-enrolment into an open defined benefit or hybrid scheme will not have to auto-enrol until October 2016.

The challenging period for those running and monitoring auto-enrolment will be in the period from April 2014. Over a 4-month period, some 27,000 enterprises with between 50 and 249 employees will be expected to begin auto-enrolment (unless they already do so). And then, the even bigger task – in the next 18 months, some 1.2 million enterprises with fewer than 50 employees will be required to introduce auto-enrolment. The recent difficulties encountered by a well-established body (HMRC), in administering correctly the records of millions of taxpayers, hardly bodes well for the auto-enrolment 'enforcers' (NEST, its contractors and TPR), who with far fewer resources will be expected to cope with millions of individual employee records and an entirely new compliance regime.

Elsewhere in the survey, firms indicated they wanted changes in policy that would remove micro-employers from the requirement to auto-enrol. The ACA made recommendations to the auto-enrolment reviewers that it would be wise to delay any extension of auto-enrolment to this group until there was a clearer

picture of how successfully the policy has been implemented across larger organisations. However, the reviewers and government decided not to exercise such caution and to move ahead with the already announced timetable encompassing all employers with one employee or more (although some concessions were made to exclude those on lower incomes within firms).

Figure 18: Smaller firms - awareness of auto-enrolment date for organisation



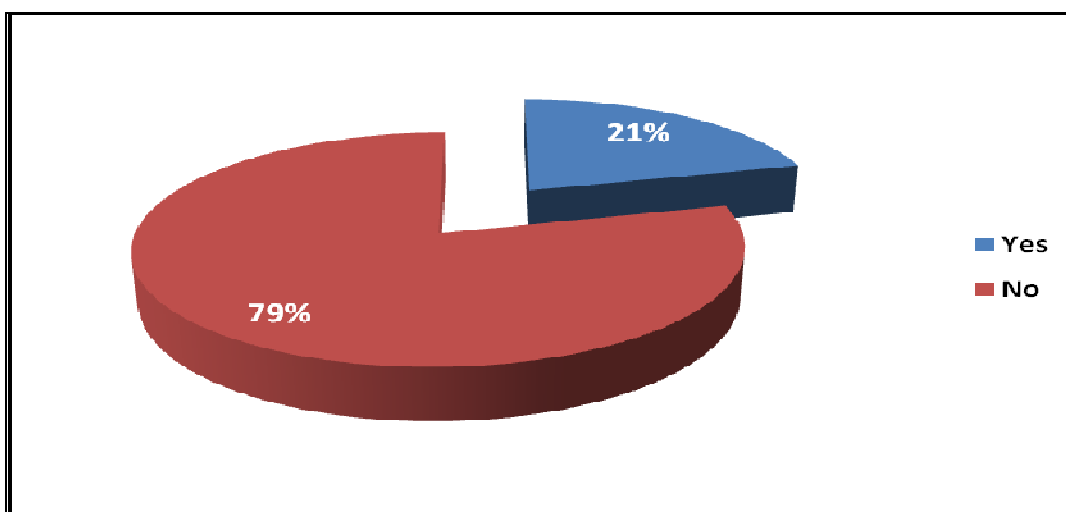
Have you budgeted for the likely increase in costs that could arise from higher scheme membership as a result of auto-enrolment?

A minority of respondents (21%) of smaller firms have at present budgeted for the likely increase in costs arising from auto-enrolment. Given the generally low level of scheme participation in open defined contribution pension arrangements reported here (see *Figure 5, page 8*), this is troubling, albeit it is three to four years before the first compulsory requirement to auto-enrol in smaller firms. **It may mean many more employers over the next three years or so will wake up to the potential costs involved and take mitigating actions, leading to an increase in scheme reviews** (this may already be evident, see *Figure 9, page 11*).

Of those organisations that have budgeted for extra costs, the average opt-out rate assumed by smaller firms is 35% (much higher than for larger firms, where our recent survey⁷ found an average anticipated opt-out rate of just 15%). For many open schemes, this suggests auto-enrolment in smaller firms might lead to modest increases in membership as low as 5% (where membership is already around 60% of eligible employees) through to +25%, where membership levels are low – potentially increasing employer pension contribution costs by similar (and often higher) percentage amounts. Where no scheme is presently in place at all, the costs falling on these smaller employers, phased in over the period 2014 to 2017, potentially will be greatest.

⁷ ACA Survey Report, *Auto-enrolment and NEST* in larger organisations, published 31 August 2010 (see: www.aca.org.uk – publications)

Figure 19: Smaller Firms - have you budgeted for auto-enrolment?



What in your view will be the most likely response of your firm to auto-enrolment and NEST?

The survey found that well over half of firms (62%) are likely to auto-enrol present 'non joiners' into their existing pension scheme(s) – in the main into GPPs, Stakeholder and trust based DC schemes. There may be some levelling-down in contributions to mitigate costs (see *Figure 20, page 22*), where current employer contributions exceed the minimum to apply from 2017 (3% of band earnings).

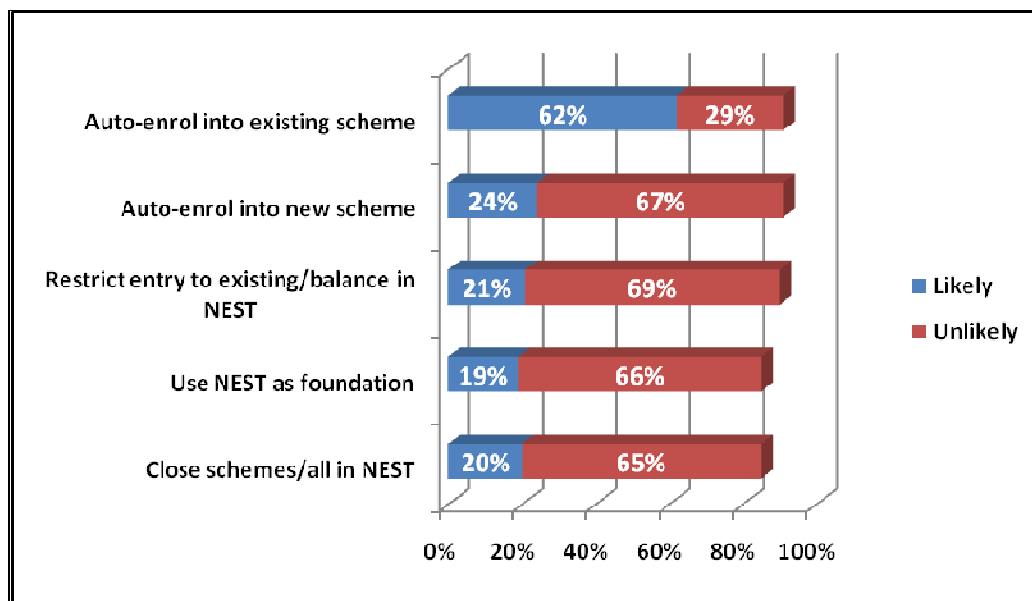
However, the results also suggest a quarter of organisations (24%) will consider auto-enrolling into a new domestic scheme, suggesting either the closure of existing schemes, both defined benefit and defined contribution, or the possibility that present 'non joiners' will be enrolled into new schemes, possibly attracting lower employer contributions⁸. A fifth say they will restrict entry into their existing schemes, auto-enrolling the balance of employees into NEST and a further fifth may use NEST as a foundation scheme, running a firm's top-up scheme above this.

Another fifth are likely to close their existing scheme altogether, largely where Stakeholder schemes have not taken off, where employer contribution levels are close to the 3% of earnings level or where present participation rates are low.

Of those firms presently not running workplace schemes, the majority are as yet undecided as to what they will do, with the remainder split between opening a firm's scheme or using NEST.

⁸ This is supported by the findings in DWP Research Report *Employers' attitudes and likely reactions to workplace pension reforms 2009*

Figure 20: Smaller firms - organisation responses to auto-enrolment and NEST

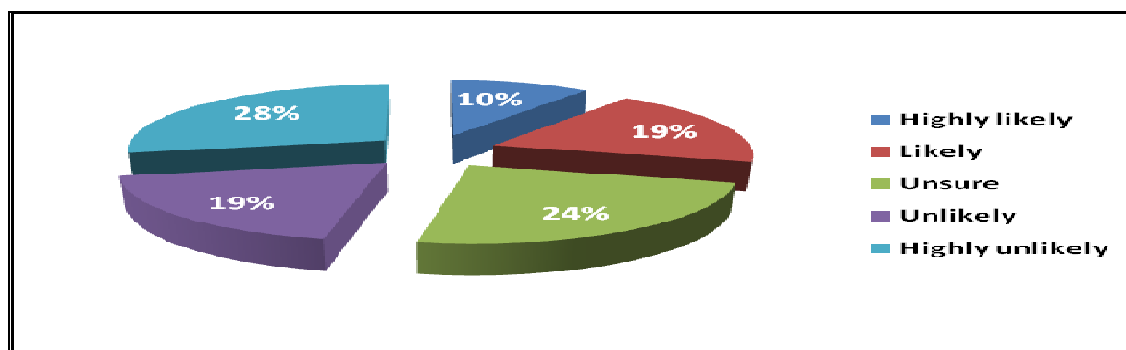


Note: Where totals are below 100%, the balance of respondents said 'not sure'.

Will you review existing scheme(s) benefits to mitigate the cost of higher scheme membership from auto-enrolment?

Three out of ten firms (29%) are likely to review existing scheme benefits/contributions to mitigate the cost of higher scheme membership from auto-enrolment. Given the numbers that have so far budgeted for the costs of auto-enrolment (21% - see *Figure 19, page 21*), this may be a number that climbs as more organisations identify potential cost increases over the next few years. Given current participation rates in schemes (see *Figure 5, page 8*), and the anticipated increases in membership expected from auto-enrolment suggested by this survey (increases in membership of 5-25% of employees), there must be the expectation of some modest levelling-down of contributions, where these are presently higher than the proposed minimum levels applying from 2017. There also may be adjustments to pay and employment levels, or lower pension contribution rates for 'non joiners' and new entrants. Much is likely to hinge on the economic situation over the next few years and how this impacts on business performance and costs.

Figure 21: Smaller firms: auto-enrolment: will your organisation mitigate the cost of higher scheme membership



Do you think auto-enrolment should be delayed or removed in respect of certain requirements?

Ahead of the results of the review of auto-enrolment conducted in the summer of 2010, the survey investigated a number of then current requirements in respect of auto-enrolment and whether any should be delayed or removed.

In fact, **respondents said none of the auto-enrolment requirements listed should be delayed**, but a majority said the following:

- **61% said those with under three months' service should not be auto-enrolled. This approach has now been endorsed by both the auto-enrolment reviewers and government**, albeit administration may not be eased completely as employees still will be able to request an earlier opt-in.
- **66% said firms with one employee (and 50% said firms with fewer than five employees) should be removed from the auto-enrolment requirements.** This approach was rejected by the reviewers and government.
- **53% said the requirement to auto-enrol every three years should be removed.** This approach was also rejected by the reviewers and government.

Encouragingly and giving support to the auto-enrolment project, smaller firms opposed decisively the exclusion of firms with five or more employees from the requirement to auto-enrol. However, if the auto-enrolment policy had been reviewed to exclude firms with just one employee, then this would have reduced the number of firms that the new regime would need to manage by some 190,000. More significantly, excluding firms with fewer than five employees would have reduced the number of firms subject to auto-enrolment by a further 606,000. Such a decision would have greatly eased the administrative challenge faced by the new regime, whilst only reducing the numbers eligible for auto-enrolment by around 2 million (still leaving 8-9 million covered by the policy)⁹. Excluding these micro-employers need not have been a permanent decision. Once the regime had been established and been seen to work efficiently, smaller firms could have been gradually eased into coverage. Instead, by raising the earnings threshold before employees are auto-enrolled, some 600,000 employees will be excluded, but the TPR will see no reduction in the number of employers it will have to oversee.

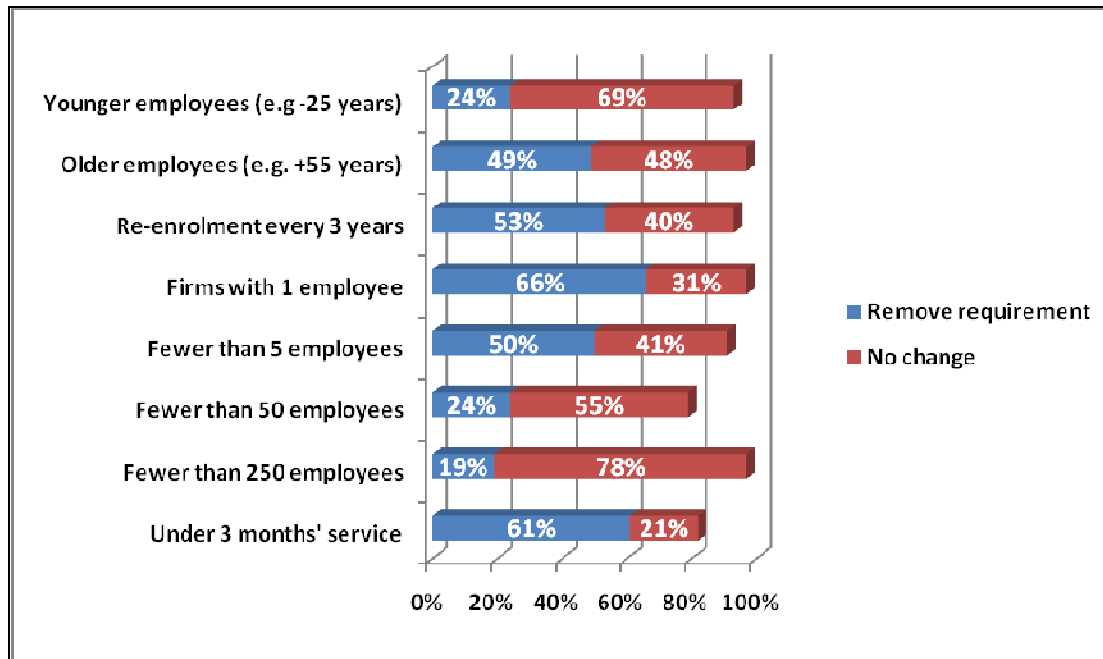
Firms were split down the middle as to whether older employees should have been excluded from auto-enrolment into a scheme/NEST (say those aged 55 or over). Some indicated that there would be a danger of a mis-sale as the amounts that might be saved until retirement may only produce sufficient income to disentitle retirees from State benefits. Set against this, others took the view that excluding older employees might stop those working on past today's retirement age from generating worthwhile funds, particularly if they work on towards 70 or beyond. The latter argument won the day with both reviewers and government.

A clear majority of firms opposed the suggestion that more young employees (those between age 22 and, say, age 25) should be excluded from auto-enrolment on the basis that many may move employments

⁹ See *Hansard*, Column 1152W, 27 July 2010: Steve Webb MP replying to a written Parliamentary Question by Angela Eagle MP.

rapidly and have other spending priorities in their early 20s. The reviewers and government supported firms' views on this issue.

Figure 22: Smaller firms: should auto-enrolment be removed as a requirement for:



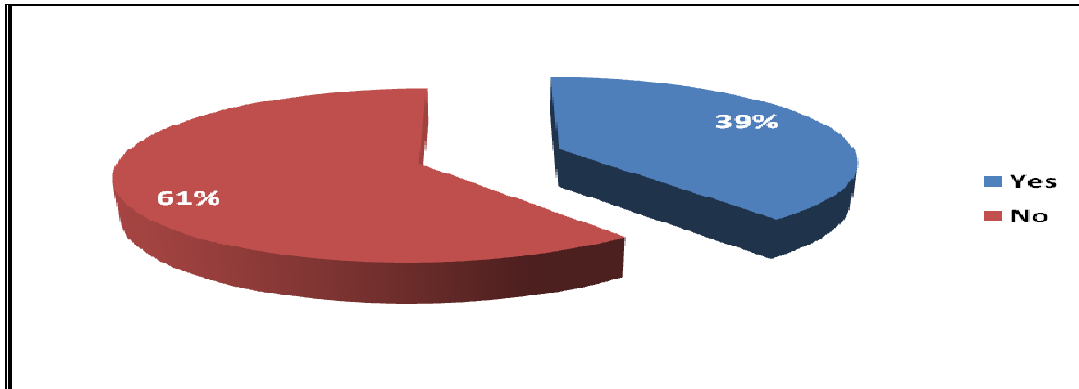
Note: where totals fall short of 100%, the balance of respondents said 'delay'

Do you think auto-enrolment should be delayed as a requirement until the Government passes legislation to allow employers greater freedom to offer more flexible pension designs than at present?

Currently, many would argue that there are too many complexities in UK pension legislation, so employers find it difficult to identify pension designs that are cost effective and flexible. In particular, the defined benefit regime is prescriptive and, as a result, the number of open schemes has reduced rapidly in recent years. As we have noted earlier, in 1996 our *Smaller Firms Pension Survey* found 82% of such schemes were open to new entrants. Just 14 years later we found the complete reverse – an ever larger number now closed. If there were to be greater freedom and flexibility in design, it is doubtful in this sector that the appetite for DB 'lite' or other risk sharing approaches would re-kindle defined benefit provision, other than at the margins by the larger firms. **However, what is relevant is that trust based defined contribution schemes run by these firms are also in decline probably due to the more onerous regulatory requirements that apply to them as against contract based arrangements.** It is important that the regulatory regimes covering such schemes are both proportionate and broadly there should be a level playing field with contract based schemes. Certainly in this sector, the potential for risk sharing by way of DC Super Trusts and, perhaps, Collective DC schemes should be considered. **Significantly, four out of ten firms (39%) said that auto-enrolment should await legislation that allows greater freedom in pension design.**

If the existing pension regimes are not eased ahead of the introduction of auto-enrolment, then it seems likely that the process of employers levelling-down existing provision (both what remains of DB and trust based DC) will continue. This may raise questions as to whether the governance of new defined contribution arrangements is as robust as it needs to be given the increasing number of employees covered by such arrangements and this is why the Pensions Regulator is about to consult on what actions, if any, are needed to improve the regulation of all defined contribution schemes.

Figure 23: Smaller firms: auto-enrolment to await Government legislation to allow greater freedom of pension design



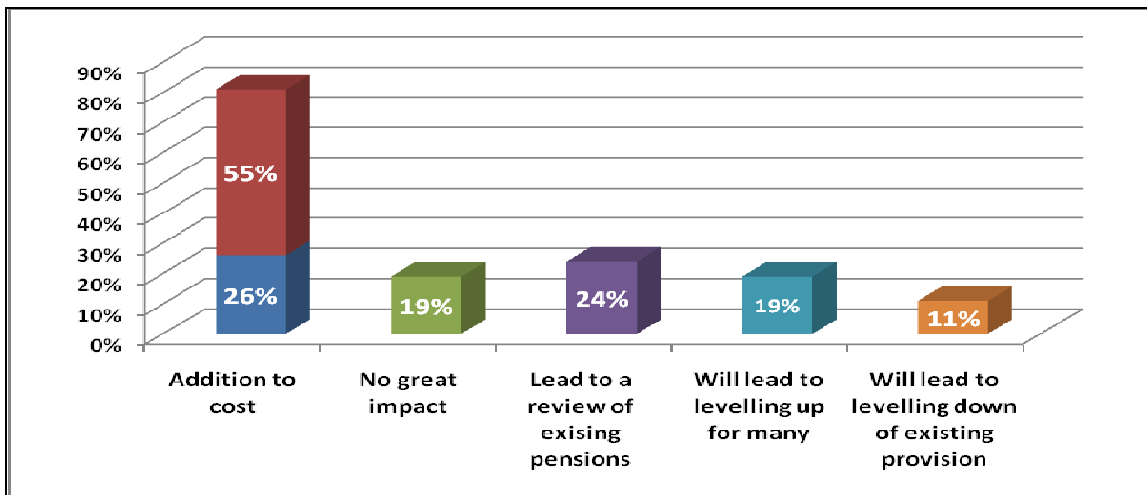
Overall, how do you think the introduction of auto-enrolment and NEST will affect your firm and workplace pension provision?

A quarter of smaller firms expect (24%) the introduction of auto-enrolment and NEST to lead onto a review of existing pension arrangements, with one in ten expecting levelling-down as a consequence.

A fifth expect levelling up for many, which is perhaps surprisingly low as expectations seem to be that many more employees will be covered by pensions than hitherto, albeit this survey also forecasts opt-out rates of around 35%.

The most serious concern must be that 55% expect a 'significant' addition to business costs and 26% a 'marginal' one. Aside from the administrative costs involved in ensuring observance of auto-enrolment rules, those smaller firms covered by this survey facing significant increases in costs will be those with no present scheme or nil/low existing levels of scheme participation, or where estimates of employee opt-outs ultimately fall short of expectations and budgets.

Figure 24: Smaller firms: overall, how will auto-enrolment impact on your organisation?



Note: 'Addition to cost' - 26% say 'marginal' additional cost and 55% say 'significant' increase in cost.

Summary of new employer duties under Auto-enrolment and NEST

The *Pensions Commission Reports* in 2005 and 2006 pointed to significant under-saving for retirement, notably amongst low-to-moderate earners, with millions heavily reliant on inadequate State pensions. The then Government responded by flagging its intention to restore the indexation of State Pension to earnings growth alongside a number of other improvements (but with the State Pension Age gradually increasing in stages to 68). Additionally, to boost pension coverage and to take in up to 10 million new pension savers, the Government accepted the need for both a low-cost national scheme (now called NEST) for employees not offered access to an employer's scheme meeting certain minimum requirements and auto-enrolment into either NEST or an employer's scheme. Following an independent review over the summer of 2010 the coalition government has made a few changes in the policy detail but has endorsed the launch of auto-enrolment and NEST from 2012.

The key features of the policy, as revised by the coalition government, are:

- a new employer duty is due to come into force from October 2012. From then, **auto-enrolment of all 'eligible jobholders'** (those aged 22 and below State Pension Age) **with earnings above £7,475pa** (aligning the threshold with the personal allowance for income tax from April 2011) into a **'qualifying workplace pension scheme' (QWPS)** will **begin as a statutory requirement** for the largest employers. Minimum contributions will however be calculated on earnings above the national insurance primary threshold £5,720pa (presently) up to £33,540pa. All these earnings figures will be up-dated for 2012.
- Medium sized and small employers will be required to auto-enrol their 'eligible jobholders' into a QWPS on a staged basis geared to PAYE references, such that all employers, including single employee firms, will be integrated by September 2016.
- 'Jobholders' aged over 16 and under 22 or over State Pension Age up to age 75 will be able to ask to be auto-enrolled into a QWPS if they exceed the updated earnings level of £5,720pa (and the employer must comply and pay the employer's contribution). If they have no qualifying annual earnings above £5,720pa, they can enrol, but no employer contribution is required. If they have earnings between £5,720pa and £7,475pa they can ask to be enrolled and their employer will have to make a minimum contribution.
- All jobholders will have the right to 'opt out' (but eligible jobholders must be auto-enrolled first) and all eligible jobholders will be re-enrolled every three years probably during a six month window, with a view to increasing scheme coverage over time.
- During the staging period up to September 2016 the total minimum pension contributions will be 2% of employee earnings, with a minimum of 1% from the employer. From October 2016 this will rise to 5% of employee earnings, with a minimum of 2% from the employer. From October 2017 contributions will be 8% of employee earnings, with a minimum of 3% coming from the employer plus 4% from the employee and 1% by way of tax relief. Earnings include salary, wages, overtime, bonuses and commission, as well as statutory sick and maternity pay. The independent reviewers recommended a 'simple system' by which employers could certify that their existing defined contribution scheme meets the required contribution levels – a principle the government has accepted.
- Defined benefit and hybrid schemes will be exempt from staging – the duty to auto-enrol will instead be delayed until October 2016.
- Employers will be able to auto-enrol eligible jobholders into a firm's own existing (or new) QWPS, when this is certified as such by the Pensions Regulator, or otherwise must enrol them in the new National Employment Savings Trust (NEST), previously known as the 'personal accounts' scheme. A firm's own scheme will only be certified as a qualifying scheme if it reaches requirements that are at least equal to or better than NEST. There will be an optional waiting period of up to 3 months before a worker needs to be auto-enrolled, although workers may opt in during the waiting period.
- NEST has been developed as a trust-based, defined contribution, portable, low-cost scheme (0.3% annual management charge plus 1.8% charge on each contribution until NEST set up costs are met), designed for the needs of low-to-moderate earners. Its investment approach will reflect the needs of these groups.
- NEST will only accept transfers in and out of the scheme in very limited circumstances, but this may be reviewed.

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Association of Consulting Actuaries

St Clement's House, 27-28 Clement's Lane, London EC4N 7AE

Tel: +44(0)20 3207 9380 Fax: +44 (0)20 3207 9134 Email: acahelp@aca.org.uk

Web: www.aca.org.uk

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