



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

13 August 2010

Paul Johnson
Auto-enrolment Review
Department for Work & Pensions
Caxton House
6-12 Tothill Street
London SW1H 9NA

Email: caxtonhouse.auto-enrolmentreview@dwp.gsi.gov.uk

Dear Mr Johnson

The “Making auto-enrolment work” Review

I am writing on behalf of the Association of Consulting Actuaries with our thoughts on the issues covered by this review.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given by our members is subject to the Actuaries' Code. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

General Comments

The ACA warmly welcomes the establishment of this independent review, and in particular its objective of making Automatic Enrolment work. There were many aspects of the previous Government's proposals which we felt were over-complex and unduly restrictive, as can be seen from our previous responses at

ACA response to Workplace Pension Reform – completing the picture – 5 November 2009
(enclosed with email), and

ACA response to auto-enrolment regulations consultation – 1 June 2009 (enclosed with email).

The previous Government's stance was consistent with ensuring that auto-enrolment reached out to the widest possible number of workers. You will no doubt be considering whether this stance remains appropriate. We believe that for many of the complexities and restrictions to be removed, a move away from this universal approach will be unavoidable.

We were also concerned with the haste with which the previous Government sought to finalise the regulations, allowing little time for consultation and setting questions that suggested that the scope of the consultation was intended to be limited. Having said this, subject to some notable exceptions, the regulations delivered by and large do achieve their objective. We therefore believe that, subject to some exceptions and simplifications, it should be possible to adapt the regulatory framework that has been set by the previous Government rather than starting afresh.

In the Appendix to this letter we have focussed on those areas in which the ACA and its members have professional expertise, in particular:

- Choosing the right group to Auto-Enrol
- Minimising the administrative burdens on employers
- The impact on existing pension provision

We conclude that the régime that was previously proposed can and should be considerably simplified. The legislative focus should be more on enablement and support for employers, and less on complex anti-avoidance measures.

We should be very happy to work with the Independent Review as its ideas develop and a new, simpler Auto-Enrolment régime takes shape.

Survey of Employers

I am also enclosing with this email a summary of the results of the ACA's survey of larger employers' views on auto-enrolment. This survey was carried out during the last two weeks and focused on employers with medium or large pension schemes; we are currently conducting a separate but parallel survey of smaller employers (250 or fewer employees) and expect the results to be available in about one month.

The most significant findings of the survey include:

- 75% of employers support the principle of auto-enrolment.
- 70% see the regulatory régime as being complex.
- Over 40% are 'likely' or 'highly likely' to consider levelling-down (reduction of existing scheme benefits) to help meet the cost of auto-enrolling additional employees.
- Support for NEST is mixed. Half of employers agree with it, while the remainder are split between those who would prefer commercial provision and those who disagree with the concept altogether.
- 73% want minimum contributions to be a percentage of basic pay rather than of full earnings.
- Over 60% say that employers with fewer than five employees should be exempt.
- 64% say that the requirement to re-enrol opters-out every three years should be removed.

We hope that you find our comments of assistance.

Yours sincerely

A handwritten signature in black ink, reading "David Everett". The signature is written in a cursive style with a large, stylized 'D' and 'E'.

David Everett
Deputy Chairman, Pension Schemes Committee

Enc: Appendix

MAKING AUTO-ENROLMENT WORK

Choosing the Right Group to Auto-Enrol

The Earnings Threshold

The annual Earnings Threshold has been set at £5,035. This was the point, in 2006/07 from which employees started to pay National Insurance contributions. We understand that this earnings threshold was intended to increase in line with the increase in average earnings from 2006/07 to the commencement of the scheme and thereafter to continue to be linked to average earnings. It would be helpful to have confirmation of this, and to have all monetary figures re-expressed in 2010 terms now.

However, the level of the threshold will depend upon its purpose. If the policy intention is that Auto-Enrolment should apply to everyone except the lowest paid, tying it to the NI threshold is logical. But given the new Government's intention of taking more people out of income tax, with an ambition to reach a £10,000 threshold over time, we can also see an argument for adopting a significantly higher Earnings Threshold. Those with very modest earnings above the Lower Earnings Limit will in any event be building up a reasonable State pension (both the Basic and the State Second Pension) and it is questionable whether they should be auto-enrolled into a pensions vehicle on which they may receive little if any tax relief on their personal contributions and quite possibly see the emerging benefits adversely impact any means-tested benefit entitlements. The impact on means-tested benefits is something to which we think that the previous Government paid insufficient attention in designing the 2012 reforms.

There will be additional issues when it comes to translating the annual threshold into a weekly or monthly figure, especially for workers whose earnings fluctuate from one pay period to the next. However these more detailed points can safely be left to a later stage in the review process.

Age Range

The Regulations provide that (subject always to the Earnings Threshold) automatic enrolment should be:

- compulsory for workers aged from 22 to State Pension Age; and
- optional between ages 16 and 22, and between State Pension Age and 75.

We do not see any particular difficulties with this, though the interaction with a changing State Pension Age will need careful communication. A case could also be made for setting the upper limit of compulsion a few years below State Pension Age, to avoid forcing individuals to build up pension savings that are likely to be very small.

Some Possible Exemptions

Micro Employers

We have seen suggestions that micro employers – those with fewer than five employees – should be excluded altogether from the Auto-Enrolment régime.

There is an obvious tension here between social policy and administrative convenience. It is undoubtedly true that involving hundreds of thousands of micro employers with NEST will create formidable practical difficulties. Simply getting the message of NEST/Auto Enrolment out to these micro employers in the first place will be a huge task as most of them have no experience of pensions and there is bound to be widespread non-compliance (whether deliberate or inadvertent). Furthermore, the administrative expense for NEST of dealing with contribution flows on this scale will be considerable.

Yet from the viewpoint of the worker, why should the size of the employer make any difference to the legislation applying to his or her occupational pension?

One way of reconciling these opposing forces would be along the following lines:

- initially excluding micro employers from the Auto-Enrolment legislation
- but allowing them to participate on a voluntary basis
- organising a widespread communication programme at grass roots level, so that all workers become aware of the position and can put pressure on their employers to participate
- placing a statutory duty upon the Trustee of NEST to review the position after (say) 12 months of operational experience with larger employers and to report back to Government in the light of that review stating what it considers to be the earliest practicable date for the inclusion of micro employers in the compulsory régime.

It is perhaps also worth pointing out the difficulties associated with including micro employers. Rates of error and administrative problems are likely to be very much higher than for larger employers; have the costs to NEST and/or the Pensions Regulator of dealing with these issues been fully recognised?

De Minimis Contributions for Money Purchase Schemes

Whatever level is chosen as the Earnings Threshold, there will be some workers, who having met the conditions for being auto-enrolled and having joined a qualifying scheme, will have earnings that are just above the threshold in one or two pay periods and whose contributions to any qualifying money purchase scheme will be only a few pounds. The obvious problem is that nobody can know in advance which workers will be in this position. Simply raising the Earnings Threshold will not solve the problem.

A partial solution to this difficulty might be to require employers to calculate the contributions in each pay period, but to refrain from actually paying them until the aggregate during a single tax year reaches a given level, say £100. This would at least avoid the need for NEST and other pension providers to maintain and service thousands of tiny accounts which are of little real use as retirement savings.

On the downside, it might be felt that this system would give some employers a perverse incentive to keep wages low, or to avoid re-employing the same worker for a second spell of work in the same tax year. However, if this is regarded as a problem it can be avoided by requiring that if the accumulated contributions remain below (say) £100 at the end of the tax year they must then be paid to the worker as a cash supplement. Obviously the contributions deducted from the worker's own pay would have to be refunded in any event.

An alternative suggestion would be to adopt a 3-month delay before auto-enrolment. At that point the employer would be required to calculate the equivalent annual earnings; if the figure was above the Earnings Threshold the employee would then be auto-enrolled.

A second test would need to be carried out at the end of the tax year, in order to pick up those employees whose actual earnings exceeded the annual Earnings Threshold even though their projected earnings did not.

Enhanced Protection Cases

At the other end of the earnings scale, there are some unintended consequences of the interaction between Auto-Enrolment and enhanced protection under the Finance Act 2004. We feel strongly that these consequences should be addressed and I attach our recent letter to HMRC setting out the details.

ACA/JWG comments on *The Occupational and Personal Pension Schemes (Automatic Enrolment) Regulations 2010* – 30 June 2010 (enclosed with email)

Timing Issues

Much of the complexity surrounding previous proposals related to issues of timing. In what follows we have attempted to identify some areas where simplification could reasonably be considered.

Transitional Periods for Defined Contribution Schemes

Originally it was proposed (in the Turner Report) that employers should contribute a minimum of 3% of the jobholder's qualifying earnings. Together with member contributions and tax relief this would make a total of 8%.

In 2006 the Government proposed a phasing-in period of three years with an unspecified period during which employers would be staged into the new regime. By the time that there was clarity on the staging period (in September 2009) it was three years. This was much more than expected and when the fog cleared earlier this year from the then Chancellor's Pre-Budget announcement in December 2009, it had been lengthened to four years.

So the current proposal is that the minimum employer contribution should be phased in as follows:

- 1% for up to four years from October 2012 (as employers are staged by size during that period)
- 2% for a further year
- 3% thereafter

While we understood the rationale for the three year staging period (the operational capacity will not exist for the Pensions Regulator and NEST to commence the employer duty over a shorter period), the rationale for the further extension was never made clear. We now have potentially up to five years during which medium to larger employers may feel pressured to "level down" their existing pension schemes to the minimum permitted level.

We would prefer to see a shorter staging period to reduce this risk, perhaps associated with putting back the October 2012 date if this is necessary for the above operational reasons.

Staging by size of employer

We commented at length on this subject in our November 2009 response (please see link above) and will not repeat those arguments here. We do however suggest that you should consider:

- changing the measure of size from “PAYE Scheme” to “number of employees/workers/jobholders paid by this employer”
- dropping the idea of selecting some small employers at random for early entry.

It would also be helpful to have clarification of the position within groups of companies. To the extent that the legislation imposes duties on employers, and especially in relation to phasing by size, is it intended that companies within the same group should be treated separately or in aggregate?

Auto-Enrolment with effect from day 1 of employment

The rules currently proposed for this are in our view too rigid. In many organisations employees are hired locally and it can be some time before information about them filters through to head office or to central payroll departments – not because of inefficiencies, but simply because it can take a week or two to collect all the necessary information.

The timescales for Auto-Enrolment need to recognise these real practical difficulties.

The interaction of Auto-Enrolment with Opting Out should also be revisited. We acknowledge the policy intention, but as currently formulated, individuals, employers and schemes will be required to carry out much unproductive work in unscrambling transient and unwanted membership.

Postponement of automatic enrolment

It is proposed that automatic enrolment will be postponed by exactly 3 months if the designated DC scheme passes a more stringent test, namely:

- aggregate contributions at least 11% with the employer contributing at least 6%
- with contributions at this level being paid for at least 3 months.

We support this idea in principle, though greater clarity about its operation would be helpful. In particular, will employers have the option of using this test or will it be a requirement?

There was a statement in the September 2009 consultation that short-term workers would be excluded from these provisions. In our view any such exclusion will make the test very difficult for employers to operate in practice.

Re-Enrolment

As the legislation currently stands, Automatic Re-Enrolment will be required every three years. However, as we said in our November 2009 response, successive Re-Enrolments are likely to produce diminishing returns: our experience is that those who have already opted out once are very likely to wish to opt out again.

Indeed, some people may be irritated at being repeatedly Re-Enrolled into a scheme which (from their perspective) they have already said they do not wish to join.

For all these reasons we would favour a “light touch” approach to Re-Enrolment, involving the minimum of paperwork. Perhaps it would even be acceptable for employers simply to draw the scheme to the employee’s attention at intervals of three years, thus giving them a regular opportunity to opt in rather than having to opt out again. The mechanics of such a low-key “reminder” could be prescribed if deemed necessary.

Transfers within a Group of Companies

This is an area where greater clarity is required. If different companies within a Group can have different Re-Enrolment dates (which seems to be the case), an employee who moves from company A to company B within the Group may in practice encounter Re-Enrolment dates that are anything between two and four years apart. There is considerable scope for confusion in this area, for example where employment is managed locally but HR records are maintained centrally.

Early Adoption of Employer Duties

The legislation as drafted would allow employers to bring forward their Automatic Enrolment dates by volunteering to become subject to the legislation at an earlier date.

Our feeling is that this may be counter-productive. If bringing the date forward means that the employer will immediately be subject to all the rigours of the legislation, including penalties for non-compliance, few employers will wish to do so! If the Government really wishes to encourage early adoption it should ensure that this can be done on a truly voluntary basis to which the regulations do not apply.

Minimising the Administrative Burdens on Employers

Payroll Issues

We have already touched on the timing difficulties associated with the enrolment of new employees. More generally, the legislation needs to recognise that there will be major impacts not only on employers’ payroll systems but also on their HR procedures.

In general – and for very valid reasons – payroll and HR systems are not integrated with each other. Moreover they are usually run by separate departments with separate management lines, and one may be devolved locally while the other is managed centrally. This legislation will require the two functions to liaise more closely and more frequently than they have typically done in the past and it will be important to allow sufficient time for employers, systems providers and external payroll bureaux to make the necessary changes.

Simplifying the DC Contribution Requirement

Much of the complication of the proposed régime arises out of a relatively simple fact: while Auto-Enrolment will ultimately require aggregate contributions of at least 8% of “qualifying earnings” (ie above a stated threshold and below a stated upper limit), pension scheme contributions are often defined by reference to basic salary only. Unless this issue is tackled, there is a real risk of levelling down.

Examining the contribution quality requirements alongside the pay reference period, it is clear that the language used in the legislation is such that either:

- the scheme must be checked on an individual by individual basis for each relevant pay reference period; or

- the design of the scheme must be such that it is clear that the quality requirements are always met for all potential members – for example, if the scheme precisely mirrors (as is the case for NEST), or improves on, the quality requirement in relation to either or both of the contribution rates and the earnings definition.

There are many good quality DC schemes that do not meet the quality requirements by virtue of their design alone. They will therefore need to carry out detailed checking. It is this fact alone that creates the levelling down risk.

In order to avert this we think that you need to revisit the legislation and be quite radical in your approach. One possibility is to introduce a number of alternative DC quality requirements. So for example, employers could be required to meet any one of the following:

- Test A – aggregate contributions of at least 8% of gross earnings above the threshold
- Test B – aggregate contribution of at least (say) 10% of basic pay above the threshold.
- Test C – aggregate contributions of at least (say) 5% of all basic pay.

An employer would be required to use one of the three tests for all its employees rather than picking and choosing between individuals.

This would provide considerable simplification at a stroke.

In putting this forward we acknowledge that there will be some cases where Test B or C produces a materially smaller figure than Test A – for example, employees with large bonuses or significant overtime earnings. However, we believe that such cases will be very much in the minority and that many of those concerned will be earning more than the upper limit of qualifying earnings on either definition. Overall we consider that the potential small reduction in retirement savings will be far outweighed by the major reduction in administrative costs and the other benefits of simplification such as lower error rates and lower regulatory costs.

The Impact on Existing Provision

Successive Governments have confirmed that they continue to support the principle of occupational pension provision, and that the Auto-Enrolment legislation is not intended (or expected) to have a negative impact on such provision.

While we warmly welcome that support, many commentators have said that in practice the overwhelming effect will be towards a “levelling down”. Their reasoning is that employers will argue: “If the Government believes that aggregate contributions of 8% are adequate to produce a decent retirement pension, why should we spend any more than that, especially in these difficult times?” Other supporting arguments include that:

- it is not sustainable to go on paying (say) 20% into a closed DB scheme as against the 3% employer contribution for members of NEST; and
- where pension coverage of a workforce is currently low, the easiest way for the employer to find the additional contributions required for NEST is to cut back on pension contributions elsewhere.

If these arguments were to gain widespread support then the objective of increasing the Nation’s overall retirement savings would not be met; instead, money would simply be diverted from one kind of pension saving to another.

On a wider view this may also prove to be the case with regard to overall levels of saving by citizens, who may not thank policymakers for requiring their resources to be re-directed from, say, ISAs into a new and unproven pensions product.

Simplifying the Exemption Criteria

Earlier this year the DWP asked us to comment on their draft guidance on the certification of DB and Hybrid schemes. We should be happy to supply a copy of our response if you wish to see it.

For DC schemes the exemption criteria are closely related to the level of the contribution requirement. We have suggested above a possible way simplifying that requirement, and we believe that if our suggestion were to be adopted the temptation to level down would be significantly reduced. **If the Government makes it easy for employers to continue with their existing pension schemes then many will happily do so.**

On the DB front the situation is inevitably more complicated but in our view the same principle should apply: make compliance easier and there will be less levelling down. We covered this subject in some detail in our November 2009 response, in which we identified the following main issues:

- Linking exemption for final salary schemes to the existence of a Contracting-Out Certificate is helpful and should be retained.
- The fact that exemption for career average schemes is not linked to contracting-out is likely to cause confusion and should be reconsidered.
- The proposed tests for contracted-in hybrid schemes are far too complicated and are wholly disproportionate to the number of such schemes in existence. They should be replaced by a simple actuarial test, along the lines of the long-standing reference scheme test for contracting-out purposes.
- Guidance for employers should be completely separate from guidance for actuaries. Each should be written with its intended audience in mind.

Finally, we question the proposal to enable employers to comply with this legislation by using a non-UK scheme. Very few employers (perhaps none) will wish to use such a facility; in our view the potential demand does not justify the additional regulatory costs involved.

“Inducements”

We accept that this Government, like its predecessor, may wish to ensure that unscrupulous employers cannot avoid their obligations by encouraging employees to opt out of pension provision.

However, the anti-inducement provisions as currently drafted are highly ambiguous. Many thousands of responsible employers, who would not dream of trying to avoid their responsibilities, are concerned that they might fall foul of these provisions simply by operating a normal flexible benefits plan (in which the employee has the ability to divert pension contributions into some other employee benefit).

It is essential that clear guidance is provided at an early date to reassure employers providing schemes of this kind.

Produced by:

Ted Belmont, Jane Beverley and David Everett for the
Association of Consulting Actuaries
St Clement's House
27-28 Clement's Lane
London
EC4N 7AE

Tel: 020 3207 9380
Fax: 020 3207 9134

13 August 2010