Implementing a National Pension Savings Scheme

10

The Pensions Commission recommends that government should create a National Pension Savings Scheme (NPSS) into which people will be automatically enrolled but with the right to opt-out. Figure 5.2 described the key principles and features of such a scheme, and Chapter 6 set out a range of possible contribution levels and illustrative estimates of fund values and pension incomes which might result from a successful scheme.

This Chapter addresses implementation issues which will need to be resolved before the scheme is launched. Under each topic we aim to identify the major decisions that need to be made, and propose outline answers. There will however need to be a major implementation, planning and consultation exercise before the scheme is launched, and it is likely that detailed work during that planning process will suggest changes to some of the proposed details, and reveal further issues to be resolved.

This Chapter covers in turn:

1. Contribution rates and covered earnings bands: default, minimum, additional and maximum contribution levels
2. Alternative pension arrangements outside the NPSS
3. The mechanics of auto-enrolment, payroll deduction, and individual opt-out: possible roles for HM Revenue and Customs
4. The treatment of the self-employed and those not in work
5. Options for reducing the cost impact on small businesses
6. Investment options: selection process and default funds
7. The decumulation phase: annuity provision and arrangements on death prior to annuitisation
8. Communication with members
9. A scheme-specific tax regime?
10. Indicative costs of operation, drawing on international experience
11. A feasible implementation timescale
12. Management and governance

1. Contribution rates and earnings bands

Chapter 6 has already discussed the issues relating to the appropriate contribution rates and the bands of earnings on which contributions should be paid within the NPSS. The key recommendations set out there were:

- We recommend that the band of earnings across which contributions should be made, should stretch from the Primary Threshold (currently £4,888) up to the Upper Earnings Limit (UEL) (currently £32,760). Both limits should increase over time in line with average earnings, thus keeping stable the range of the earnings distribution covered by the scheme.[1] The rationale for this range is that:

  - There should be an upper limit since there is a point in the earnings distribution above which it is reasonable for society to take a laissez-faire approach to the replacement rate which people achieve, given the adequate absolute standard of living which will be ensured by auto-enrolment up to that level.

  - There should be a lower limit, both to limit the proliferation of very small value accounts and because there is a level of earnings below which the state system in itself is likely to deliver an adequate replacement rate. In Chapter 6, we suggested that the lower limit should be the Primary Threshold. We recognised that setting it this low might result in a significant level of opt-out among those only slightly above the Primary Threshold, but we believe it important to allow most people the option of participating in the NPSS and thus of receiving the benefit of the employer matching contribution. This is particularly important given that there will be many people with earnings not far above the Primary Threshold at specific points in their lives but who have lifetime earnings high enough that they will wish to make pension provision above the flat-rate which the state will provide.

[1] While up-rating of the threshold with earnings should be the standard, the trends in earnings amongst lowest earning groups should be monitored to ensure that indexation of the Primary Threshold does not result in an increasing proportion of the workforce falling below the threshold for participating in the auto-enrolment part of the NPSS.

- The band of earnings we suggest would be within the range of those used by other countries for the mandatory earnings-related pension system [Figure 10.1].

- We recommend that the total default contribution rate should be around 8% of gross earnings between the Primary Threshold and the UEL. This proposed 8% contribution would arise from a combination of (i) individual contributions paid out of post-tax earnings; (ii) the benefits of tax relief; and (iii) the matching employer contribution.

  - The tax relief element could arise from the operation of the current tax relief regime. The alternative approach, an explicit "government match" payment, is considered in Section 9 of this Chapter. If we use the current tax relief system then the tax relief for contributions is around 1% of the total 8% contribution, but in addition people gain the benefit of the tax-free lump sum. In a matching system the up-front match would be worth 1.5% of the total 8%, but with no tax-free lump sum subsequently enjoyed.

  - The case for proposing a compulsory matching employer contribution was set out in Chapter 5 Section 1, and Chapter 6 set out our recommendation that the employer contribution should be 3% of earnings above the Primary Threshold and below the UEL. This matching employer contribution would only be payable where the individual remained auto-enrolled and made individual contributions. It would be equivalent to about 2.3% of total gross earnings for the median earner on £22,000 per year. Since however pension contributions are not subject to employers' National Insurance (NI) contributions, it would add only about 2% to the cost of employing the median earner, and only in the case of those companies not presently making pension contributions of 3% or more. The impact on the cost of employing lower earners would be less than this. Overall, we estimate that the introduction of the NPSS, under reasonable assumptions about participation rates, would add about 0.6% to total labour costs in the private sector [See Section 5].

One issue not discussed in Chapter 6 was the age from which auto-enrolment should commence. There is a strong argument that it should not be 16, the age at which people usually enter the tax and National Insurance system. Auto-enrolling young people working part time whilst still in school, higher or further education is likely to result in high levels of opt-out and large numbers of small value accounts, both of which will tend to increase average administration costs, both within the NPSS and for business. It may also tend to create a habit of opting-out which then prevails at later ages.

Figure 10.1 Earnings bands used for earnings-related pension provision in selected countries

Country	Lower limit	Upper limit
Australia	Minimum threshold of 15% median full-time earnings (£2,334 per year).	Upper limit of around 300% median earnings (£52,527 per year).
Sweden	Lower limit is linked to prices. In 2004 it was around 6% of median full-time earnings (£1,221 per year).	The upper limit is linked to earnings and is around 120% of median full-time earnings (£23,332 per year).
USA	Earnings are credited for social security when they exceed 9% median earnings in a quarter (£2,021 per year). The lower limit is increased in line with prices.	The upper limit is increased in line with earnings and is around 260% of median earnings per year (£47,407 per year).

Source: MISSOC 2004, Savings Product Working Group (2004), www.ato.gov.au/super, (limits for 2003/04), www.ssa.gov (2003 limits) OECD earnings deciles statistical information 2003.

Note: All figures have been converted to pounds sterling at the current exchange rates (10th October 2005).

In Chapter 6 we modelled likely results of the NPSS on the assumption that people would on average start saving for a pension at 25. Some young people will however wish to begin saving at an earlier age, and ideally should be able to do so, gaining the benefits of low costs and the matching employer contribution. The Pensions Commission, therefore, favours an earlier age, such as 21, for the start of auto-enrolment.

Figures 10.2 and 10.3 set out the replacement rates as a percentage of earnings which the proposed contribution rates might produce given different rates of returns and different retirement ages (assuming that on average saving commences at age 25). Chapter 6 illustrated how these income streams from the NPSS, combined with state pension income, would make it likely that people would achieve the minimum base load of earnings replacement which we believe the state should strongly encourage.

But these default rates will not secure the replacement rates to which many people will aspire. And there will be some people who wish to contribute to the scheme but at a lower level than the default. Two issues therefore arise:

(i) Should it be possible to contribute more than the default contribution and should there be a maximum?

(ii) Should it be possible to contribute less than the default contribution?

(i) Contributions above the default rate up to a maximum

There are very strong arguments for allowing employees and their employers to make contributions, on a voluntary basis, above the default level:

- Many individuals will wish to make pension provision above the minimum default level, and should be able to do so without the complexity of multiple pension arrangements, and enjoying the opportunity to save at low costs which the NPSS will deliver.

- Many companies are already making pension contributions more generous than the modest compulsory level within the NPSS. It should also be possible for employers to make higher contributions when enrolling their employees in the NPSS without the complication of creating a further scheme.

Figure 10.2 Replacement rate from NPSS for someone age 20 today: earnings level and rates of return scenarios

Rate of return	£10,000	£15,000	£20,000	£25,000	£30,000
2%	9%	11%	13%	13%	14%
3%	11%	14%	16%	17%	17%
4%	14%	18%	20%	21%	22%
5%	17%	22%	25%	26%	27%

Notes: Assumes total contribution of 8% between the Primary Threshold and UEL from 25 retiring at 67. The AMC is 0.3%.
Earnings in 2004 terms, increasing in line with average earnings.

Figure 10.3 Replacement rate from NPSS for someone age 20 today: earnings level and retirement age scenarios

Retirement age	£10,000	£15,000	£20,000	£25,000	£30,000
65	11%	14%	16%	16%	17%
66	11%	15%	16%	17%	18%
67	12%	16%	18%	19%	19%
68	13%	17%	19%	20%	20%
69	14%	18%	20%	21%	22%
70	15%	20%	22%	24%	24%

Notes: Assumes total contribution of 8% between the Primary Threshold and UEL from 25.
The real rate of return is 3.5% and the Annual Management Charge is 0.3%.
Earnings in 2004 terms, increasing in line with average earnings.
These replacement rates assume continuous saving from 25 to the age shown. In judging the level of contribution required to be reasonably sure of achieving a 15% replacement rate (in Chapter 6 Section 3) we allowed for some interruptions to work between 25 and SPA.

There is, however, a case for limiting the size of these additional contributions. Our macroeconomic analysis in Chapter 6 Section 6 suggested that the total aggregate value in NPSS accounts would not be so large as to raise concerns about the proportion of total national investment flowing through the NPSS and thus, for instance, about the percentage of total investment which might take an indexed form. If, however, contributions to the NPSS were entirely uncapped, and if it was perceived as a highly cost-efficient investment vehicle, the aggregate size might conceivably grow to a level at which such concerns were valid.

We therefore believe that there is a case for a cap on contributions, and recommend that the approach of setting a maximum cash limit to contributions should be considered. This could be set at a level equal to twice the default level contribution (employee and employer combined) for the median earner i.e. about 16% of relevant earnings (this would currently be about £3,000 per year). This approach would mean that lower earners would effectively be free of any cap (since they would be unlikely to be able to use the full freedom) while limiting the extent to which higher earners could use the NPSS as a low-cost alternative for pension saving that is already in many cases occurring [Figure 10.4].

As well as allowing further contributions on top of the default level, however, it will be important for government strongly to encourage such additional contributions. One risk in establishing a default rate of contribution to the NPSS is that it may be seen as a standard, to which some employers may level down even while others level up, and that individuals will wrongly assume that default level contributions are by definition adequate. Evidence from occupational schemes shows that when individuals are auto-enrolled, contribution rates tend to cluster around the default level [Figure 10.5].

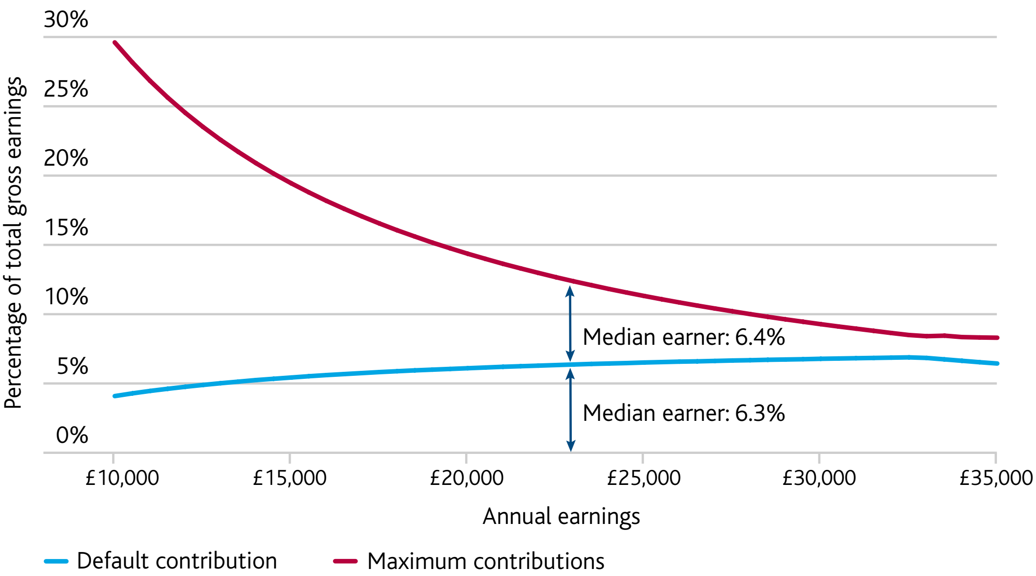
To overcome these dangers it is essential that the introduction of the NPSS is accompanied by communication which:

- Stresses that the NPSS default level contributions should be seen as a minimum level, in the same way as the National Minimum Wage is seen as a minimum level of hourly pay, and that most people will want to consider making additional contributions.

- Explains the opportunity to make additional contributions, and indicates the contribution rates which may be needed to achieve a range of different income replacement rates.

- Reminds employers and employees of the fact that, as Chapter 7 outlined, paying people via pension contributions is highly cost-effective given the benefits of tax and National Insurance relief.

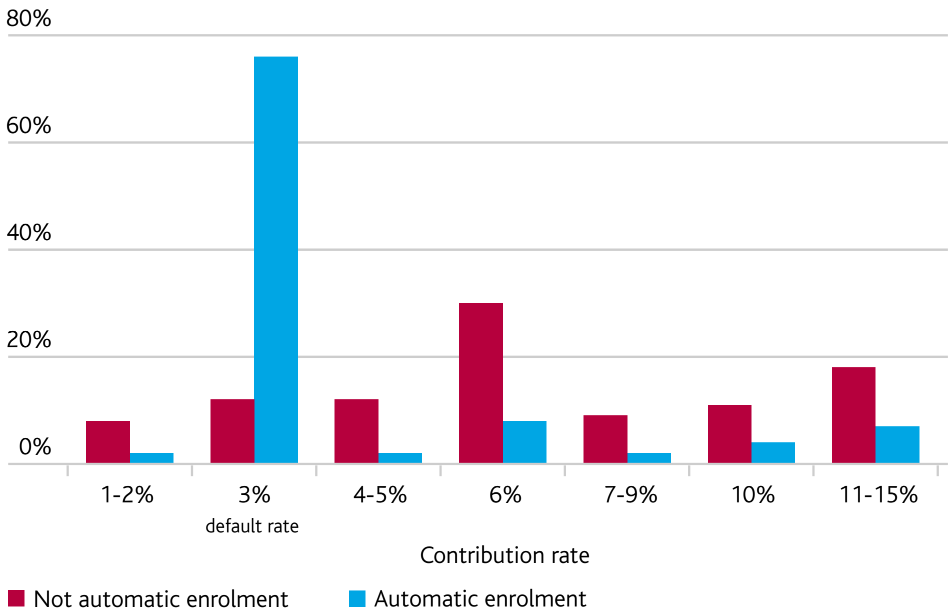
Figure 10.4 Effect of maximum contribution cap at different earnings levels



Source: Pensions Commission analysis

Notes: This assumes a default contribution rate of 8% of earnings between the Primary Threshold and the UEL. The maximum contribution is £2,920 in 2005 earnings terms.

Figure 10.5 Contribution rates in US pension plans: impact of default rate and auto-enrolment



Source: Madrian and Shea, 2001

Notes: Default contribution rate equals 3%.

(ii) Contributions below the default level

A case could also be made for allowing individual contributions below the default level. This would for instance enable individuals who felt unable to make the full individual contribution at least to maintain some level of pension saving. But we believe that there are strong counter arguments against allowing regular contributions below the default level, collected via payroll deductions, as it would add significant complexity in company payroll administration, and would fail to send a clear signal that the government believes that almost all people should be encouraged to save at the default level or above. Whether individuals who are members of the NPSS but who are currently temporarily opted-out of regular contributions, should be able to make ad hoc individual contributions direct to the NPSS is an issue for further consideration.

2. Alternative pension arrangements: better provision outside the NPSS

The NPSS is designed to ensure that those people not presently covered by adequate pension arrangements are enabled and strongly encouraged to save for a pension, while their employers are required to make a modest matching contribution. It is not intended, however, to replace existing good pension provision and it is important that the introduction of the scheme allows companies or individuals who currently have good arrangements in place to continue with these.

In respect of individuals who wish to make different arrangements, there is no need to specify what those alternatives might be. Any individual who wishes to opt-out of the NPSS on an individual basis would be free to do so whether this means foregoing the employer matching contribution, or receiving an employer contribution into another scheme. There will therefore be no need for new legislation relating to existing personal pension provision.

Where companies wish to maintain existing arrangements instead of auto-enrolling employees in the NPSS, however, legislation will be required to ensure that the existing pension arrangements are at least as favourable as those which the NPSS would provide. As Chapter 7 Section 1 has already set out, this implies that companies wishing to stay outside the NPSS arrangements, either for all of their employees or for some, will need to meet two sets of conditions [Figure 10.6]:

- Levels of employer contributions, and of combined employer plus employee contributions, which exceed the default level in the NPSS.
- Auto-enrolment procedures which achieve the same strong encouragement as that achieved within the NPSS.

Figure 10.6 How employers could opt-out of the National Pension Savings Scheme

DB, DC or hybrid schemes could be eligible to opt-out of the NPSS if:

1. **Overall benefits in/contributions to the scheme equal to or above NPSS levels**

   - DB scheme benefits accrued by most members to exceed estimated default level NPSS benefits.
   - For DC scheme contributions:
     - Employer contributions of at least the level of compulsory match in NPSS.
     - Total employee and employer contributions, net of all costs and fees, at least at the level of default contribution in NPSS (net of costs).

2. **Auto-enrolment**

   - To opt-out the company must either:
     - auto-enrol all employees who would otherwise qualify for NPSS into the occupational scheme;
     - or, if the occupational scheme has restricted access (e.g. a waiting period), the employer must operate two schemes. Employees eligible to join occupational scheme must be auto-enrolled into it. Employees not eligible for the occupational scheme must be auto-enrolled into the NPSS.

But one consequence of encouraging the continuation of existing scheme arrangements, will be that individuals may, at different points in their life, accumulate pension rights within employer schemes outside the NPSS as well as within the NPSS. Current pension transfer regulations allow individuals to demand a transfer of accumulated funds out of occupational schemes and into Stakeholder Pension policies,[2] and recent tax simplification changes have been designed to facilitate such and other transfers, by removing tax treatment distinctions between different types of scheme. There is no reason why similar transfer arrangements should not apply to transfers from occupational schemes to the NPSS, thus allowing individuals if they wish to consolidate their pension saving. There may be a case for limiting the maximum value of such transfers in the same way as we have proposed limiting maximum annual contributions. The pros and cons of this and the appropriate maximum level are issues for consideration and consultation.

3. The mechanics of auto-enrolment, payroll deduction and individual opt-out

The aim of the NPSS is to use the power of inertia strongly to encourage individuals, and their employers through the matching contribution, to make at least minimum pension provision, while leaving individuals ultimately free to opt-out if they wish. It also aims to make low cost saving available to all people, and to minimise the administrative burdens on business. Achieving these objectives requires careful design of the mechanics of contribution collection and individual opt-out.

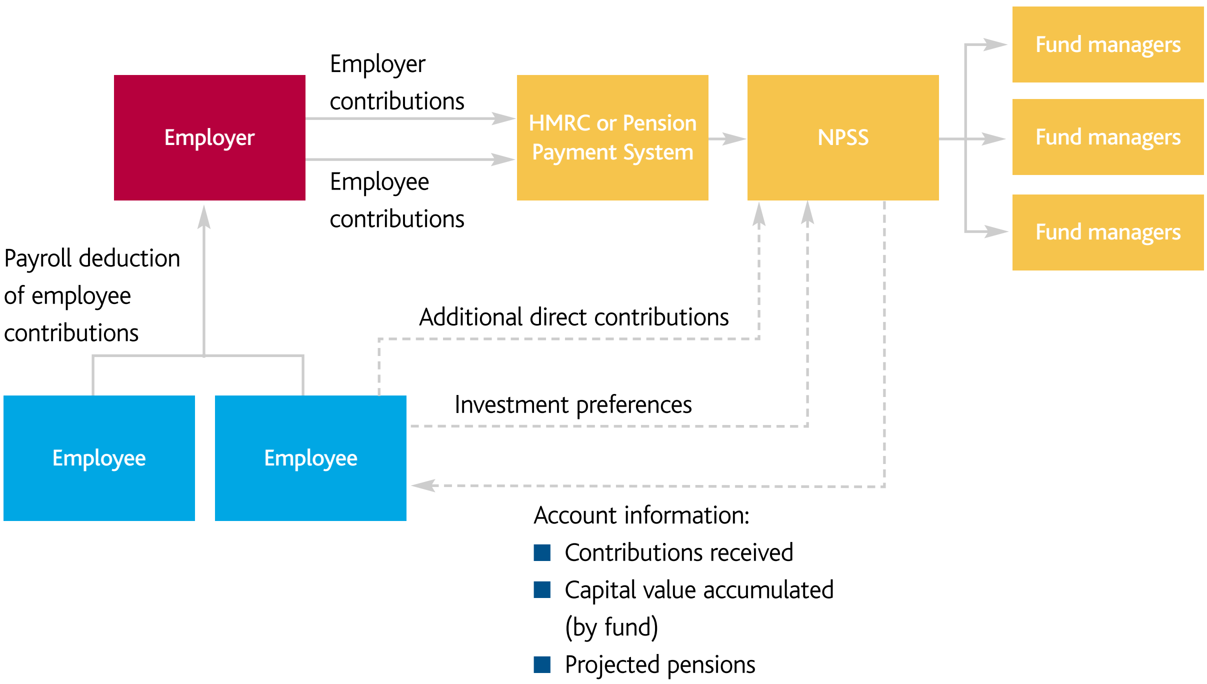
(i) Collection of NPSS contributions

Key features of the proposed NPSS were described in Chapter 5 Section 1 and summarised in Figure 5.2. The features include [Figure 10.7]:

- Individual accounts are held at the NPSS, which invests the individual's money in funds as chosen by each individual, and which provides information direct to the individual about the capital value accumulated.
- Contributions are deducted from payroll, and then sent to the NPSS using a unique account number identifier (which should almost certainly be the individual's National Insurance (NI) number).

[2] Other schemes (e.g. occupational schemes) may choose to allow a transfer in of rights (in the case of DB schemes) or funds (in the case of a DC scheme) but it is at the discretion of the trustees.

Figure 10.7 National Pension Savings Scheme: Key Flows



Issues relating to investment fund choice, to communication with members, and to the governance of the NPSS, are discussed in Sections 6, 8, and 12 below. This section discusses the payroll deduction and contribution processing system.

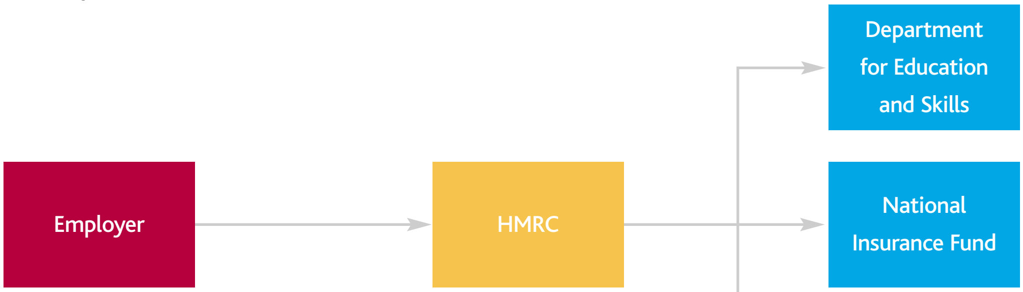
It is essential to design this process so as to minimise administrative burdens on business and to minimise public administration costs. There are two options for achieving this. One is to use the PAYE system, the other to create a new Pension Payment System, specifically designed to process payments to the NPSS. In both options companies only have to make payments to one entity, and can use the NI number as the unique individual identifier. But there are important trade-offs to be considered in choosing between the two options: the PAYE option may minimise costs and business complexity (though this is not entirely clear): but the dedicated Pension Payment System option has a crucial customer service advantage:

- **The PAYE option**. All companies already have to make payroll deductions which are expressed as percentage rates over defined bands of earnings for tax and NI purposes. They combine these individual payroll deductions with employer NI contributions and send money to HM Revenue and Customs (HMRC). They use each individual's NI number to identify contributions per individual, and these are then credited to the individual's account within the National Insurance Recording System (NIRS2). This system is already being used for purposes other than tax and NI payments: student loan repayments are collected through this route. There is therefore a strong case in terms of simplicity for using the PAYE system to collect contributions (both employee and employer) to the NPSS. We believe that the costs of collection via the PAYE system would be very small in relation to both total fund size and overall operational costs.

  Using the PAYE system, however, would suffer from one major disadvantage. This arises from the time delay between employer payments of aggregate PAYE and the provision of individual specific information. At present companies pay each month to HMRC the aggregate company liability for tax, NI, and other deductions collected via the PAYE system [Figure 10.8]. But only after the end of the tax year do they provide, through the P14 and P35 forms, information specifying the breakdown of the payments to the individuals concerned. Individual accounts within the National Insurance system and within the Student Loans Company are therefore credited up to six months after the end of the financial year in which the deductions from the individual's pay were made.

Figure 10.8 Transfers of contributions and information in the Pay As You Earn system

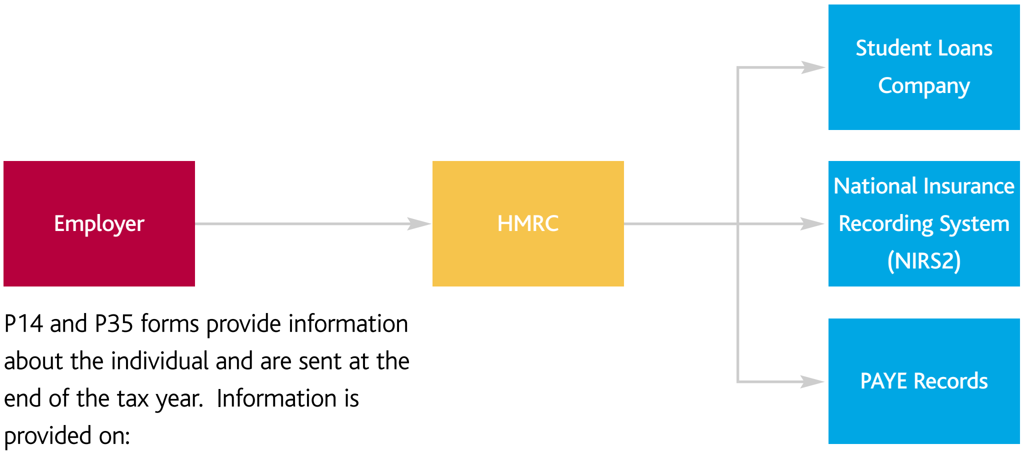
Monthly: Transfers of contributions



- Aggregate tax and NI contributions
- Student loan deductions
- Construction Industry Scheme payments[1]
- Taking account of recoveries of statutory payments and tax credits

Transferred quarterly based on previous year's totals

Annually: Transfers of information



P14 and P35 forms provide information about the individual and are sent at the end of the tax year. Information is provided on:

- Pay
- Total tax
- Total National Insurance
- Student loan repayments

[1] The construction industry scheme is a specific scheme for the construction industry whereby contractors pay their subcontractors net of tax and National Insurance contributions.

Applying this system to the collection of NPSS payments would therefore have two important disadvantages:

- It would be impossible for people's contributions to be allocated to specific funds in line with each individual's choice until the individual's specific information arrived. All contributions would therefore have to be held in, say, a risk-free gilts fund for, on average, about a year after they were made.

- More seriously still, it would be impossible, without adding additional information requirements, to identify when precisely in the year deductions had been made, and thus to give the precise appropriate return on each individual's funds in the period prior to investment in line with the individual's choice.

- **A dedicated Pension Payment System**. The way round these problems is to create a new payment system, specifically dedicated to receiving from employers, each month, both the aggregate employee and employer contributions to the NPSS and information which identifies, by use of the NI number, the breakdown of contributions by individual. The operating costs of this system may not be radically different from that involved in adding functionality to the HMRC system, but it would be, at least minimally, more burdensome on business. The calculations involved to determine individual payroll deductions and aggregate payments would be the same as for the PAYE option, but individual data would have to be sent monthly rather than at the end of the year.

The costs, administrative complexities for business, and implications for customer service, of these two options should be investigated further during implementation planning, but the Pensions Commission's current thinking is that the dedicated Pension Payment System route is likely to be preferable.

(ii) Auto-enrolment and the individual opt-out

The basic concept of the NPSS is that there should be an age at which individuals should be automatically enrolled (auto-enrolled) into making contributions. Section 1 above suggested that that age should be 21. It will also make sense to trigger the auto-enrolment process, for those who initially opt-out, at subsequent dates or events. We suggest that a reasonable approach would be to require auto-enrolment on each new employment, and every three to five years even if someone stays within the same employment. In addition, an opted-out individual could voluntarily opt to join the scheme.

The technical issues, which need to be resolved, are therefore: How would the process for opt-out actually work? And what frequency of "changes of mind" should be allowed?

- **Mechanics of individual opt-out**. There are two different ways in which opt-out could be arranged. One maximises the power of inertia: the other reduces administrative complexity:

  – In the first, an employer would auto-enrol an individual at, say, their 21st birthday, or on first joining the company, and would automatically deduct from their first pay packet the default level of contribution. The individual would be notified that, if they did not wish to stay enrolled, they must fill in the opt-out form (in paper or online) and send it to the NPSS who would then instruct the employer to cease deductions. Those who choose to opt-out would then receive a repayment of the first month's contributions (either from the employer or from the NPSS, depending on which of the two contribution payments approaches discussed above had been implemented).

  – In the second model, which New Zealand is proposing to adopt, employees will have to inform the NPSS in their first four weeks after starting employment (or after 21st birthday) if they do not wish to join. Payments would then commence only at the end of the second month.

  The Pensions Commission's judgement is that the second option is preferable. One potential disadvantage of this option is that new employees, who were already members of the NPSS in their previous employment, might unnecessarily miss a month's contribution. This can be overcome by recording prior membership on the P45 or P46 forms, and deducting contributions from the first month for new employees who are already members.

- **Subsequent opt-out and opt-in**. Clearly there need to be procedures for a member already opted-in to the scheme to opt-out, and to cease contributions, even without a change in employment. Our present recommendation is that individuals should be free after six months, on giving one month's notice to the NPSS, to exercise opt-out. Similarly it is important that they should be free to change their mind and opt-in. Again, we recommend a six-month delay before this is allowed, with a maximum of two "changes of mind" (in either direction) allowed in any one year. This seems likely to strike a reasonable balance between the need to allow individuals the flexibility to respond to changing circumstances, and the extra administrative burden, for both the NPSS and for employers, if more frequent changes were allowed.

The appropriateness of the rules established initially could and should be reviewed in the light of emerging evidence of actual behaviour.

4. Treatment of the self-employed and those not in work

In our First Report we identified the self-employed as a group among whom the problems of pension under-provision are especially severe. In Chapter 6 we described how the situation would get worse if current state system indexation arrangements continue indefinitely, since the relative value of the Basic State Pension (BSP), the only element of the state pension system to which the self-employed have access, will decline. We also, in Chapter 6, discussed the extreme difficulties in bringing the self-employed compulsorily into the State Second Pension (S2P) system, but argued that they should at least be able to join S2P on a voluntary basis.

Similar issues arise in relation to self-employed membership of the NPSS. The self-employed settle up for tax, most of their NI contributions, and student loan repayments, via self-assessment statements of liability after the end of the tax year (though with "payments on account" during the year).

This makes it very difficult to design a system of auto-enrolment for the self-employed. "Auto-enrolment" for the self-employed can only really mean designing their tax/NI assessment forms in such a way as to present the option of joining the scheme as the most obvious choice. Clearly, however, the self-employed should be able to join the NPSS on a voluntary basis. A process should ideally be created therefore to make it easy for the self-employed to become regular saving members of the NPSS. This might be achieved by allowing the self-employed to make payments to the NPSS alongside their monthly Class 2 National Insurance contributions. We recommend that this option should be investigated.

Voluntary membership of the NPSS should also we believe be open to the currently economically inactive (for instance those not currently doing paid work due to caring responsibilities) and the unemployed. Current rules allow anyone, irrespective of earnings, to make contributions to a Stakeholder Pension scheme up to a maximum of £2,808 per year and to receive in addition tax relief at the basic rate of 22%. We recommend that the same rules should apply within the NPSS.[3]

5. Options for reducing the cost impact on small business

In Chapter 5 [Figure. 5.5] we illustrated what the impact of each 1% of compulsory employer contributions would be on the wage bill for different sizes of companies, if we assumed 100% participation of those employees not currently in a pension scheme. In Chapter 5 we recommended that the compulsory matching employer contribution should be set at 3%. We also, for the purposes of our modelling, assumed that average participation rates of 80% for those above the LET and 65% for those between the Primary Threshold and the Lower Earnings Threshold (LET) might be achieved.

[3] This treatment does not apply at present to occupational schemes, where tax relief is given at each person's marginal tax rate and can thus be 10% or indeed 0% depending on earnings.

Figure 10.9 Possible impact of a National Pension Savings Scheme on private sector total labour costs

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

Source: Pensions Commission analysis of ASHE 2004

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

The possible actual effect of the NPSS on private sector labour costs, combining these two assumptions, is shown in Figure 10.9. The impact on larger firms, for instance with more than 250 employees, would be small, about 0.4% of the total wage bill on average. This reflects the fact that the majority of firms of this size already make employer contributions at or above the default level which we propose. But the average percentage increase in the wage bill would increase as firm size falls, reaching an estimated 1.0% for firms with fewer than five employees. This is the inevitable consequence of the fact that existing pension participation among such firms is very limited. The overall average cost for all firms would be 0.6%.

The argument can be advanced that the actual long-term cost to employers will be considerably less, and indeed in the very long term close to nil. Economic theory suggests that the impact of requiring companies to provide some remuneration in a deferred non-cash form will over time be offset by a lower rate of increase in cash remuneration. When Australia introduced compulsory employer contributions indeed this trade-off between pension contributions instead of cash wage increases was overtly stated and understood by employers, employees and trade unions. But such offset effects will take time to work through, and the initial introduction of the scheme will produce some increase in total labour costs, with a higher percentage increase for smaller companies.

The question therefore arises whether there are any ways in which these effects can and should be mitigated. One option, which could be considered is the phasing-in of the employer contributions over say two to three years. An alternative option which has been suggested to the Commission is that there should be an exemption for very small companies, for instance for businesses with fewer than five employees. The arguments against this are, however, compelling. It would deny the advantages of the scheme to employees in precisely the segment where pension scheme provision is most deficient. And it would create a disincentive for small companies to expand employment above the size threshold and an incentive to split businesses into different legal entities each just below the threshold.

More appropriate options to explore would instead be:

- Offsetting adjustments to the small company corporation tax rate.

- Or a mechanism by which each company received a rebate of employer contributions up to an amount fixed in absolute sterling terms, both to reduce the contribution cost and to compensate for the administrative burden. This would be a similar approach, for instance, to the rule by which companies with fewer than 50 employees receive £250 off their tax bill if they file tax accounts online, a sum of money which is materially beneficial for very small companies but trivial to large companies, and which can thus be withdrawn above the 50 employee threshold without creating any perverse incentive effects.

  Spending money on such a mechanism would be an appropriate use of the enhanced government cash flow which would result from the abolition of the contracted-out rebate for DC schemes since it would devote the money to national savings rather than current consumption.

We recommend that government should explore whether these or other options can be afforded.

6. Investment options: selection process and default funds

Within the NPSS members will be auto-enrolled into making payroll deductions (with matching employer contributions) which will accumulate in their own account: they will then choose between different funds into which their money would be invested. The key questions which therefore arise are:

(i) How wide should be the range of funds in which people can choose to invest and what should be the role of the NPSS in selecting these funds, negotiating fees and monitoring performance?

(ii) How often should people be able to change fund allocations?

(iii) Should there be a default fund into which people's money is invested if they fail to make a specific asset allocation?

These issues are considered in turn below.

(i) Range of funds provided and role of the NPSS

As Chapter 5 Section 5 discussed, one of our reasons for proposing an individual account based NPSS is that it will allow people to choose between different risk and return combinations in the light of their own circumstances and preferences. The NPSS will therefore have to make available a reasonably wide spectrum of asset allocation options, ranging from low risk/low return to high risk/high return. Individuals would be able to allocate their funds across a mix of these different asset classes, subject either to a minimum percentage of the individual's total funds or minimum absolute amounts invested in each fund. The issue is how wide this choice should be and how many funds should be available.

One possible way forward is to follow the Swedish "open system" approach, in which any fund manager can register a fund, as long as basic standards are met and as long as the fund management fees are transparently expressed [Figure 10.10]. Around 700 funds are now registered under the Swedish system. This "open system" maximises theoretically available choice. There are however three strong arguments against it:

- It is not the best way to minimise costs. While fund management charges are not the most important consideration in cost control (see the panel at the end of Chapter 1 and Section 10 of this chapter) their minimisation via economy of scale purchase can still make a significant difference to the Annual Management Charge (AMC). Average fund management charges within the Swedish Premium Pension scheme (PPM), for funds other than the default fund, are currently running at about 0.42%, well above the costs paid by large occupational pension funds (the Swedish default fund however has a fund management charge of 0.15%). An alternative model is therefore that the NPSS bulk negotiates a small number of fund management mandates focusing particularly on major investment categories (e.g. bonds, UK equities, European equities, global equities) and probably on index rather than actively managed funds. This is the model pursued by the US Thrift Savings Plan (a DC plan for Federal employees) which achieves total charges of below 0.1% [Figure 10.11].

Figure 10.10 Features of the Swedish Premium Pension Scheme

Information provision and switching frequency	■ Information via website plus booklet to all new entrants on: management charges and past performance data for each fund. ■ Members can allocate account across five different funds. ■ Switching investment allocation allowed on a daily basis at nil cost.
Fund choice	■ Free market: fund managers can register up to 25 funds each provided they comply with: – EU unit trust rules (undertakings for collective investment in transferable securities directive); – PPM rules on rebates and fund switching; ■ Currently 670 funds registered by 80 fund management companies. ■ Default fund (AP7) is state managed: 82% invested in equities with wide global spread. ■ Over 90% of new members now make no active selection, instead accepting the default fund.
Management and administration costs as proportion of value	■ Fund managers charge their market fee but with discounts (rebates) proportional to total value invested. ■ Average post-rebate charge for all funds 0.43% (arithmetic non-weighted fund management charge average). ■ Default fund: AMC is 0.15%. ■ Premium Pension Scheme (PPM) administration charge is 0.22% in addition.
Reforms under discussion	■ Significant concerns that fund proliferation confuses people and increases costs. ■ Review of scheme costs and efficiency by Professor Hammarkvist. ■ Concludes better guideance is necessary for fund choice. Given market concentration, a reduction of number of funds to 100-200 will not adversely affect choice.

Source: Social Insurance Office (2004) Information from the Premium Pension Authority; Weaver, K (2004), Hammarkvist, K (2005)

Figure 10.11 Features of the Thrift Savings Plan for Federal employees in the US

Information provision and switching frequency	■ Online information on daily account balance and fund allocations. ■ Call centre support. ■ Fund choice is restricted to 6 funds. ■ Switching investment allocation allowed on a daily basis at nil cost.
Fund choice	■ A choice of five investment funds invested in specific asset classes: – G Fund: Government bonds. This is the default fund. – F Fund: Fixed Income Index – C Fund: Common Stock Index – S Fund: Small Capitalization Stock Index – I Fund: International Stock Index ■ L Fund is a life-styling option; balanced mix of all five funds. ■ To invest in the non-default fund an individual must acknowledge the investment risk.
Management and administration costs as proportion of value	■ Investment expenses and administrative expenses together around 0.06% (2004). ■ Charges have halved since 1993. ■ Low costs are partly achieved through the bulk purchase of a limited number of funds. ■ But some administration costs (e.g. contribution collection, some member contact and information provision) is being absorbed within the human resource function.

Source: www.tsp.gov

- There is extensive evidence that too many options make it more difficult for people to make a choice. Research has revealed for instance that participation rates in US company pension schemes decline when asset allocation choice becomes extremely wide [Figure 10.12]. In the Swedish PPM scheme meanwhile expanding choice in the "open system" has been matched by an increasing number of people choosing the default option [Figure 10.13].

- A constrained choice within the NPSS does not exclude the possibility of other investment choices, since people who wish to invest in a wider range of assets will be able to opt-out.

Detailed decisions on the range of funds to be provided within the NPSS and the role of the NPSS in negotiating them, should be made after further analysis of other models and after consultation, but the Pensions Commission's preliminary recommendations are that:

- The NPSS should negotiate fund management mandates covering major asset classes (e.g. 6-10 in number) aiming for very low fees in return for the expectation of large fund volumes. These should include indexed funds.[4]

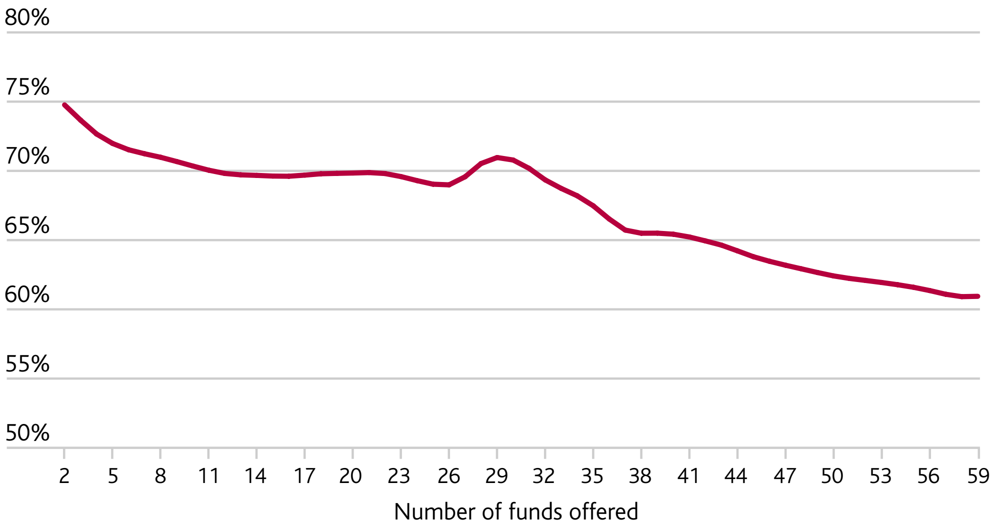
- These funds could either form the totality of the NPSS system, or could be combined with the ability to offer other funds at non-negotiated fees. This latter approach would allow members the option of investing in what are sometimes labelled "alternative asset classes" (e.g. private equity funds or hedge funds) or in funds designed to be ethical, environmentally responsible, or appropriate to particular religious groups. This could help avoid what might otherwise be contentious debates about what funds of these types should be included in the core range of bulk negotiated funds.

(ii) Frequency of asset allocation changes

The Swedish PPM scheme allows individuals to change allocations over the internet on a daily basis. While this has the apparent advantage of increasing choice, in fact frequent changes in asset allocations of an individual's pension fund make little sense. Most people investing in pensions should take a medium-term point of view about their own appropriate balance between risk and return, and make fairly slowly moving asset allocation choices, which reflect that balance. Frequent changes of asset allocation moreover increase administrative costs, which must either be recovered from the individuals concerned (which would involve a more complex charging system) or recovered via an increase in average charges imposed on all members.

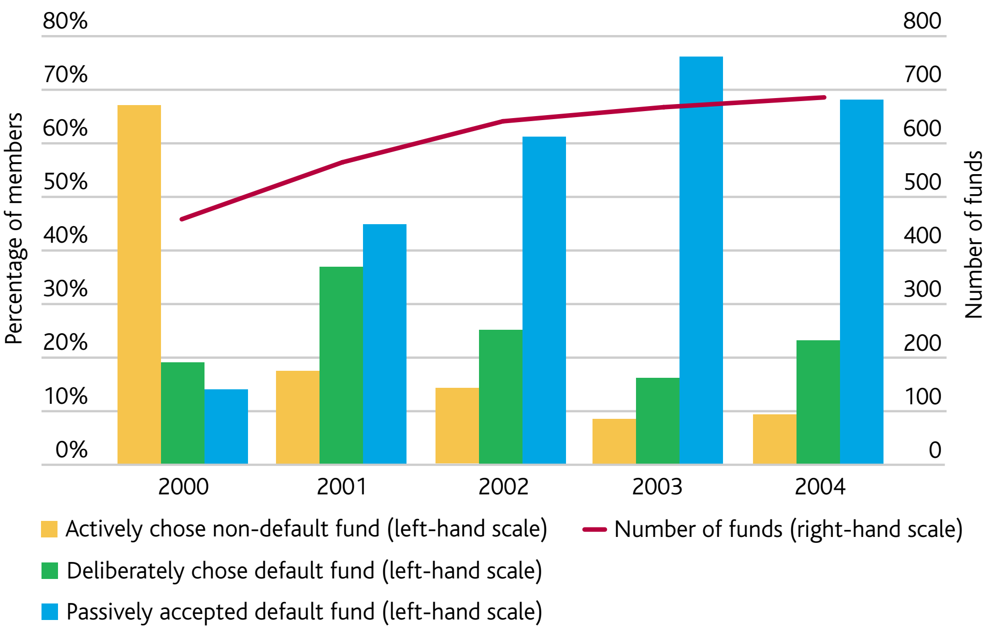
[4] Issues such as the length of mandates and whether there should be one or several mandates for any one asset category will need careful consideration.

Figure 10.12 Participation rate in US company pension plans as fund choice increases



Source: Iyengar, 2003

Figure 10.13 Active fund choice versus passive acceptance of default options within Swedish Premium Pension Scheme



Source: Weaver, 2004

Notes: Percentage of members actively choosing non-default fund from PPM administrative data. The split of those in default fund between "deliberately chose" and "passively accepted", is estimated from survey data.

Final decisions should reflect more detailed consideration and consultation, but the Pensions Commission's recommendation is that asset allocation choices should be made either on an annual or semi-annual basis.

- This would reflect typical practice within occupational Defined Contribution (DC) schemes which allow individual asset selection [Figure 10.14].
- And would enable asset allocation choices to be informed by the periodic communication of fund values and of integrated pension statements, considered in Section 8 below.

(iii) Should there be a default fund and if so what form should it take?

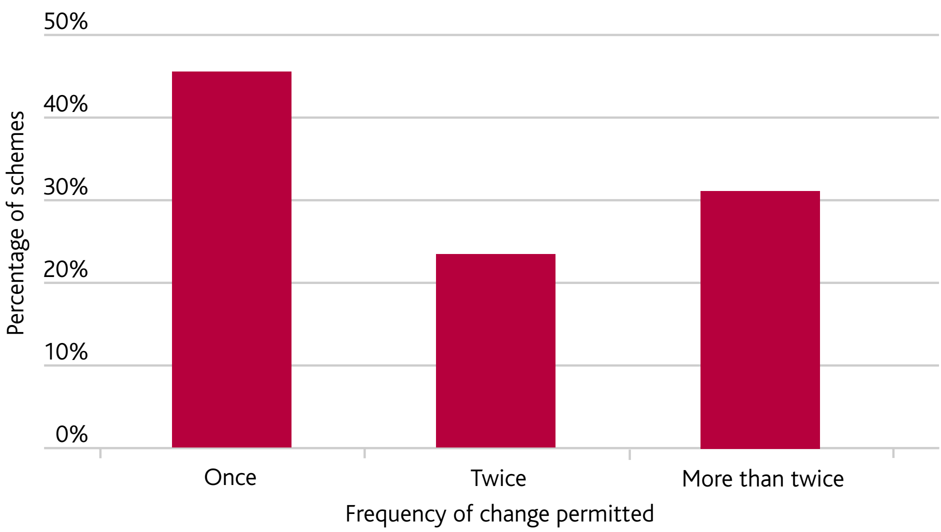
As already discussed in Chapter 5 Section 5 there are two reasons why the NPSS will need to have a default fund into which individuals are invested if they do not specify a preferred asset allocation:

- Some people simply will not send in asset allocation forms. At the very least therefore compulsory or auto-enrolled DC systems always need to have a "pending fund" (usually cash or bonds) into which funds are put while awaiting instructions.
- Many people do not feel well-equipped to make asset allocation decisions and welcome the "implicit advice" inherent in the designation of a default fund. Most DC occupational funds which allow member fund selection therefore specify a default [Figure 10.15]. These are typically either low risk/low return funds (e.g. in bonds) or "lifestyle" smoothing funds, which move people from equity rich portfolios to bond rich portfolios as they approach retirement.

Chapter 5 Section 5 discussed the considerations which should guide the designation of a default fund within the NPSS. These have led us to conclude that:

- The default fund should be a "lifestyle" smoothing fund, which automatically shifts members from high equity allocations at earlier ages to index bond allocations as they approach retirement. Within the spectrum of specific "lifestyle" fund designs it should probably be towards the cautious end. But it should be made clear that the government provides no guarantee of a minimum return on this fund, and that it could under certain (however rare) circumstances perform worse than real government bonds.
- There will be some individuals, who would prefer to invest with minimum or no risk. The other options should therefore include a fund invested in real government bonds, the return on which, looking forward from any one date, can be guaranteed.

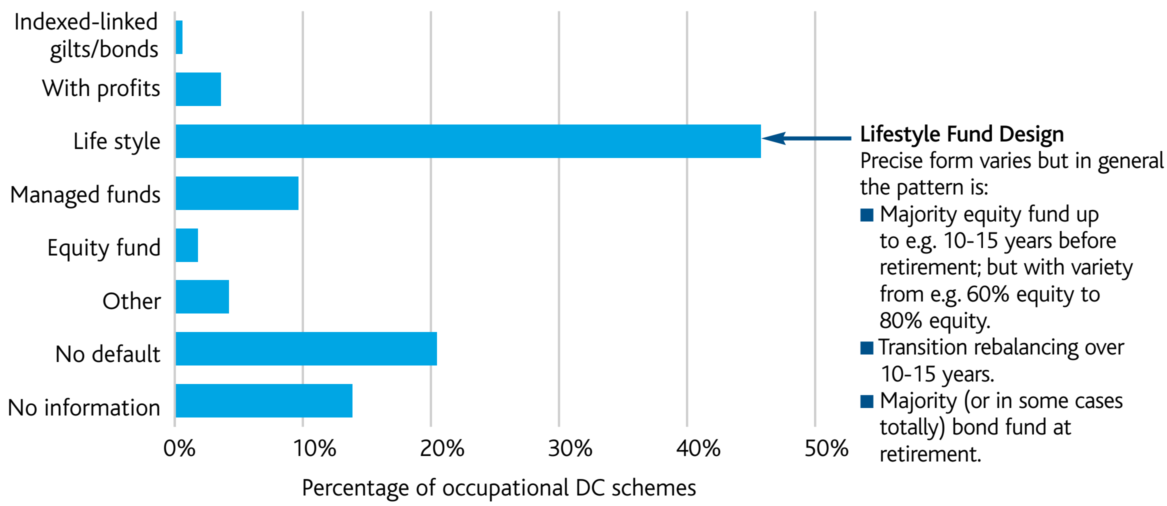
Figure 10.14 Permitted number of fund allocation changes per year for UK occupational Defined Contribution schemes



Source: Occupational pension schemes 2004, GAD

Note: Based on 77 occupational DC schemes.

Figure 10.15 Default funds in occupational Defined Contribution schemes



Source: Annual survey 2004, NAPF

Note: GAD evidence drawn from a larger sample suggests: lifestyle funds 44%; Other types of default fund 31%; No default 16% (GAD 2004).

7. The decumulation phase: annuity provision and arrangements on death prior to annuitisation

The detailed design of the NPSS will need to specify rules and arrangements relating to the decumulation phase of an individual's account. There are three issues which need to be considered:

- Should accumulated funds have to be annuitised in retirement, and if so at what age, and should the legislation define the precise form of annuity (level or index-linked, single or joint life)?
- How and by whom should annuities be provided? Is there a necessary government role in providing annuities or in supporting the annuity market in other ways?
- What should be the treatment of the assets of people who die before they have annuitised their assets?

(i) Should annuitisation be compulsory?

The NPSS is designed to ensure that people achieve at least a base load of pension income in retirement, thus limiting the danger of any means-tested reliance on the state, or of political pressure for ad hoc rather than pre-planned changes in the generosity of the state system. It is not focussed on increasing the pension savings of people already in good occupational schemes, but on ensuring that people who currently accrue nil or minimal private pension rights at least achieve a basic level of income replacement. There is therefore a strong argument that at some point in retirement the funds accumulated within the NPSS should be subject to the same annuitisation rules that apply to existing pension funds. These rules cover the first and last ages of annuitisation, drawdown before annuitisation and the choice between level and indexed, and single and joint life annuities [Figure 10.16]. (The issue of whether the NPSS should have a tax free lump sum on retirement is considered within Section 9.)

The most straightforward way to set the ages of first allowed and last possible annuitisation within the NPSS would be to align them with the current rules which apply to existing pension schemes, and we do not see any good reasons to divert from this approach. After 2006 the age of the earliest possible annuitisation will move to 55, while the age of last possible annuitisation is currently 75. Both these ages should increase in line with life expectancy, to encourage both later retirement and later annuitisation, which (as the panel on annuities at the end of Chapter 5 argued) is the key development required to offset potential strains in the annuity market. Communication to members should make plain the benefits of enhanced income which individuals might expect via later annuitisation, (provided life expectancy estimates are not subject to further unexpected upward revisions).

Figure 10.16 UK pension system annuity rules: as from April 2006

Lump sum	■ Guaranteed Minimum Pension[1] must be taken in entirety as a taxed income stream. ■ For Protected Rights[2] and all other pension saving 25% of the pension fund may be taken as a tax-free lump sum.
Earliest age at which pension benefits can be accessed	■ State Pension Age for Guaranteed Minimum Pension. ■ 55 for Protected Rights and all other pension rights.
Forms of income stream before age 75	■ No requirement to draw down any income until age 75. ■ For those who do choose to access fund there are two alternatives: annuitisation or income drawdown. The rules on type of annuity vary between Protected Rights and other pension funds.
Annuities	Protected Rights: ■ Must purchase a price-linked or with-profits annuity. ■ Those married or in a civil partnership at the point of annuitisation must purchase a joint life annuity with the Protected Rights. Non-protected rights: ■ There are no restrictions on the type of annuity that can be bought with non-protected rights.
Income drawdown	■ Individuals can draw income equal to 35%-100% of the equivalent annuity, while leaving the fund invested in asset allocation of individual's choice. ■ Survivors can inherit the remaining funds taxed at 35% (before inheritance tax).
Trivial commutation	■ Possible voluntarily to commute small pensions (up to 1% of lifetime allowance) between ages of 60 and 75, within a 12 month period. ■ Commuted pension taxed as income.
Forms of income stream after age 75	■ At age 75 must buy either: – annuity; – or from April 2006 will be able to choose Alternative Secured Income (ASI).
Alternative Secured Income (ASI)	■ Aimed at individuals unable to buy an annuity for faith reasons. ■ Maximum income is 70% of the equivalent level annuity. ■ No return of unused funds on death: individuals taking less than the maximum can receive higher pension in later years or provide for dependents' benefits.

Notes: [1] Guaranteed Minimum pension refers to that element of the Defined Benefit (DB) pension arising from contracted-out rebates before 1997.
[2] Protected Rights refer to that element of the DC pension arising from contracted-out rebates.

Turning to the form of the annuity – single or joint life, level or index-linked – there are two different approaches currently applied within existing parts of the UK pension system:

- For those DC funds (occupational or Approved Personal Pension) which arise from the compulsory savings system (i.e. from contracted-out rebates) regulation requires that annuities mimic the nature of S2P Pay As You Go (PAYG) rights. Under the "protected rights" rules they have to be joint life in form (where there is a spouse) and indexed to price increases (with equivalent rules also for contracted-out Defined Benefit (DB) rights).

- For any DC funds not funded by the contracted-out rebate, however, there is no requirement to buy either joint life or index-linked annuities (though, somewhat inconsistently, regulations do limit DB funds in both respects, even on rights above and beyond those funded by the contracted-out rebate). The majority of annuities bought with maturing DC funds (occupational or personal) are in fact single life and non-indexed.

Arguments can be made for either approach, to each of these two issues, in respect to NPSS funds:

- **Indexation**. In general most people would be well-advised to take index-linked annuities in retirement. Many people fail to understand the impact of non-indexation over lengthy periods of retirement, and many pensioners are as a result left with declining real income which they are likely to find inadequate late in retirement. The only argument in principle for level rather than index-linked annuities is that some people may prefer a higher real income early in retirement. The issue of whether higher real consumption early in retirement, declining later, reflects logical preferences rather than an unplanned and unintended result, was considered in Chapter 4 of the First Report. There is also however a pragmatic argument advanced that index-linked annuities can be poorer value than level annuities, if the supply of real-indexed instruments to support annuities is for some reason constrained [see the panel, "Meeting the increased demand for annuities," Chapter 5 for discussion of the real-indexed securities market].

  Balancing these considerations the Pensions Commission's recommended approach to annuity indexation within the NPSS is as follows:

  – Since the NPSS is the planned replacement for a compulsory earnings-related scheme, which in both its PAYG and contracted-out variants requires indexation there should be a preference in principle for price-indexation, in the NPSS. Estimates of what pension income the NPSS will produce, both for the purposes of policy analysis and to be included in communications to members, should assume that index-linked annuities will be purchased.

  – The government should, as the panel at the end of Chapter 5 sets out, ensure that there are no artificial barriers to the supply of index-linked government bonds.

– Guidance to individuals approaching retirement with NPSS funds should set out the advantages in principle of price-indexed annuities.

– But individuals should be free to decide if they wish to purchase non-index-linked annuities.

- **Joint or single life**. The argument in favour of joint life annuities is that many spouses (primarily women) of people taking out single life annuities are often left with inadequate pension income late in retirement, and are often dependent on means-tested benefits. The counter argument is that we should be aiming to create a pensions system in which all individuals should accrue adequate pensions in their own right (rather than through their spouses).

  If our recommendations relating to state pensions are accepted, this will make the flat-rate state pension more generous, more favourable to carers and less means-tested. Spouses will also wish to make decisions which reflect their individual circumstances. We therefore recommend that members should be able to choose joint or single life annuities.

  To address concerns about dependent spouses, however, one option which should be considered is whether people with spouses buying annuities with NPSS funds should need to provide a form signed by their spouse, acknowledging that they have considered the relative merits of joint and single life annuities.

(iii) Annuity provision: is there a role for government?

The overall issue of whether the government needs to take measures to support the annuity market was considered in Chapter 5 Section 3, in which the following conclusions were suggested:

- The government, which is significantly exposed to post-retirement risk through state pension provision and through health service provision, should be very wary of taking on longevity risks which the insurance industry and capital markets are capable of absorbing through the provision of annuities.

- The most important initiatives required to avoid capacity constraints in the annuities market are to encourage later retirement and later annuitisation by: (i) gradually increasing the legally defined ages of first possible and last possible annuitisation; (ii) facilitating the growth of drawdown products which delay annnuitisation; (iii) allowing annuity price differentiation by age to send appropriate signals to individuals about the benefits of later annuitisation. Free market price differentiation should also play an increasingly useful role in enabling some lower income groups to secure the higher annuity rates which should logically arise from their lower life expectancy.

- Given such initiatives, the annuity market should be able to support the significant expansion of demand for annuities arising out of the switch to DC (including the impact of the NPSS).

- However there may be a role for government in supporting the annuity market by: (i) considering the issue of longevity bonds which absorb the tail of very late post-retirement longevity risk but only if it is simultaneously taking measures to exit from inappropriate longevity risk absorption, and (ii) ensuring that there are no artificial barriers to the provision of real-indexed rather than nominal government bonds in order to support as best possible the provision of real-indexed annuities.

The implication of this overall approach is that government should not be the actual provider of annuity capacity but should rely on private sector capacity to provide market priced annuities. In operational terms, however, there is still choice to be made between:

- The NPSS bulk buying annuities from the insurance industry, quoting prices to individuals, and administering the actual payment of pensions.

- The NPSS requiring individuals to shop around for pensions in the open market.

The argument in favour of the former approach is that it could deliver better value for customers. The arguments for the latter are that: (i) the annuity market is fairly efficient and transparently priced; (ii) many people will wish to aggregate several different pension pots into one annuity; (iii) people should be able to consider drawdown options as well as straight annuities for NPSS funds; and (iv) the NPSS should limit its operational challenges by keeping out of the annuities payment business.

On balance the Pensions Commission believes that the latter arguments are compelling, and that the NPSS should not in general be a direct provider of annuities. We recommend, however, that it should have the legal powers to play a bulk-buying negotiating role if this seems likely to be able to deliver better value to specific categories of members (e.g. members with smaller accumulations whom the financial services industry will find less economic to serve on an individual basis).

We also recommend that the development of the annuity market and its capacity to absorb the rising demands placed on it, should be one among the issues which a successor body to the Pensions Commission [discussed in Chapter 11] should keep under regular review.

(iv) Assets of people dying before retirement/annuitisation

Different pension systems treat the implicit or actual assets of people who die before retirement ages differently [Figure 10.17]:

- Within the UK Basic State Pension (BSP) and State Second Pension (S2P) systems, surviving widows gain benefits (in the form of widow's pension) from the contributions which their deceased husbands have made. From 2010 this will also be the case for widowers. But in the absence of a surviving spouse, the value of contributions made accrues to the system, not to children or other inheritors.

Figure 10.17 Inheritance rights for survivors in the event of death before scheme pension age

Scheme	Inheritance rights for survivors
State Second Pension and SERPS rights	■ Surviving spouse or civil partner entitled to pension equal to half of accrued rights when reaching State Pension Age. ■ Spouses receiving child benefit can receive widowed parent's allowance. ■ Bereavement payment (£2,000) paid to all surviving spouses. ■ If no surviving spouse money does not enter estate.
Contracted-out rights (Protected Rights or Guaranteed Minimum Pension)	■ DB schemes: Immediate pension to surviving spouse equal to half of accrued rights. Can be withdrawn if spouse remarries before State Pension Age. ■ DC schemes: Accrued fund can be used to buy immediate annuity. If no spouse, the fund becomes part of the estate. ■ If the widow(er) dies then the Protected Rights pension can continue to be paid for dependent children.
Common practice for survivor's benefits in non-contracted out DB schemes	■ No statutory rules. ■ Most schemes provide death-in-service benefit to spouses and civil partners. Few withdraw the pension on re-partnering. ■ Most provide spouses' pension based on a proportion of either accrued rights or prospective pension at normal pension age. ■ Most also provide a lump sum payment.
Common practice for DC schemes and personal pensions (non-protected rights)	■ Usually the member nominates a person to inherit the pension fund (which may or may not be the surviving spouse). ■ If there is no nominated beneficiary, the value of the fund becomes part of the estate taxed at 35% (before inheritance tax).
Swedish Premium Pension (compulsory funded scheme)	■ The Swedish Premium Pension (like the Swedish PAYG NDC pension) pays no survivors' benefits in respect of those dying before claiming a pension. Instead the assets are evenly distributed between individuals in the same cohort as a survivor's bonus.
Danish ATP (compulsory funded scheme)	■ Single capital payment equivalent to 35% of fund paid to spouse.

- Within the Swedish earnings-related Notional Defined Contribution system (NDC), an explicit decision has been taken that the balances of people dying before retirement should accrue to the benefit of all survivors (i.e. to the scheme) thus slightly increasing the rate of return earned on balances.

- Within most privately funded systems, however, the accumulated balances of people who die before annuitisation accrue either to the individual's estate or, within trust-based schemes, to beneficiaries determined by the trustees (influenced usually by expressions of wish).

Our strong recommendation is that the latter approach should be followed for NPSS assets, since the attractiveness of the scheme will be significantly enhanced if people are confident that their fund assets will pass to their family (or to other specified beneficiaries) if they die before pension payment commences.

8. Communication with members

The NPSS aims, via auto-enrolment, strongly to encourage and to enable people to save adequately for their retirement, while leaving individuals free to decide whether to remain members and at what level to contribute. It is therefore vital that communication with members is designed to enable them, as best as possible, to make intelligent and informed decisions.

Designing the communication package will require careful consideration of:

- The benefits of providing guidance about the consequences of different levels of saving and different asset allocations, versus the dangers of providing implicit advice and false assurance.

- The benefits of providing a totally integrated picture of each person's pension saving (state, NPSS and private) versus the administrative complexities involved.

- The frequency of communication, and the importance of clear branding.

(i) Benefits of information and guidance versus dangers of implicit advice and false assurance

Clearly communication to members will need to inform them on the basic facts of their NPSS account: the capital sum already accumulated, the allocation between different funds, and the rate of return achieved (and thus the increase/decrease in capital accumulated) over the past period.

But there are difficult judgements to be made relating to the description of funds available, and to how much "indicative projection" information should be provided:

- **Fund description**. In many private occupational DC schemes where members can make asset allocations, descriptions of alternative funds are provided, characterising them on a spectrum from low expected return/low risk to higher expected return/high risk and providing details of historic performance. An equivalent approach will be appropriate within the NPSS. The challenge for the NPSS is that any guidance provided by a government agency will be assumed to carry authority, and, unless disclaimers are clear, to be forms of guarantee. The NPSS will need to frame descriptions in a way that makes it clear that indicative returns are no more than indicative. A clear description of the risks and possible returns within the default fund will clearly be essential.

- **Indicative projections**. There would clearly be value in providing members with indications of how already accumulated capital would grow in future under different rate of return assumptions, and of how different rates of savings, combined with different rates of return, would translate into total capital accumulated at point of retirement. Information on what future capital accumulations would mean for annual pensions, given current annuity rates, and at a variety of different ages, should ideally be included, helping people to understand the income benefits of later retirement and later annuitisation. These should reflect the assumption that people should select index-linked annuities, and should illustrate the implications of the joint life versus single life annuity choice.

Indicative projections of this sort are provided in many pension systems. Occupational DC schemes in the UK are required to provide "Statutory Money Purchase Illustrations" indicating how capital might grow and what future pension might result, given a maximum 7% nominal return assumption. Personal pensions when sold have to provide indications of future possible pension using three alternative return assumptions, 5%, 7% and 9% [Figure 10.18]. The Swedish NDC scheme, meanwhile, provides an interesting model of indicative forecasts of future pensions at different retirement ages [Figure 10.19].

Careful consideration will, however, have to be given to the precise design of indicative projections within an NPSS, given, in particular, the potential for very different results from different asset allocations. Thus:

- The Swedish communication package (the "orange envelope") has two attractive features. It provides a very clear description of the capital value of funds invested in the PPM element of the system [see the left hand side of Figure 10.19]. And it illustrates the different levels of pension which an individual might achieve at different possible retirement ages (61, 65 and 70) thus helping people to understand the retirement age/income in retirement trade-off [see the right hand side of Figure 10.19].

- But it makes these projections on the basis of the unrealistic assumption that the PPM funds will earn the same rate of return as that paid on the much larger Notional Defined Contribution (NDC) funds. This extremely cautious assumption minimises the risk that the state will have provided false assurance about future retirement income, but in the Swedish system, does not result in a dramatic underestimate of future retirement income, since the NDC funds (on which the rate of return can be predicted with reasonable accuracy) dominate the system.

- In the NPSS, however, all of the individual's funds would be exposed to the performance of the asset classes in which he or she had invested.

- But the more detailed and differentiated the indications provided of potential returns by asset class, the greater the danger that members believe that the government is providing an authoritative forecast.

The appropriate balance of these considerations will be a key issue for implementation planning.

Figure 10.18 Information to members of private pension schemes: regulatory requirements

DB occupational schemes	Currently no obligation on schemes automatically to send out annual statements, (though many do). Schemes must provide information on request, about member's own and any survivor's benefits at normal pension age. DWP is currently consulting on whether annual benefit statements should be automatically issued to active and some deferred scheme members.
DC occupational schemes, stakeholder and personal pensions[1]	With a few exceptions, schemes are required to send a benefit statement to all members annually. This must include information about: ■ Current capital value of the fund; ■ Illustration of the pension payable on retirement in today's prices (assuming normal pension age for the scheme or State Pension Age); The illustration must be calculated in accordance with technical guidance from the actuarial profession (maximum 7% nominal return but must reflect likely returns. Schemes can show a range of returns)
Stakeholder and personal pensions	FSA regulations require that at the time of initial sale illustrations of pension payable on retirement (in today's prices) are provided on the basis of investment returns of 5%, 7% and 9%.

[1] Also Defined Benefit schemes with money purchase components (e.g. AVCs).

Source: DWP

Figure 10.19 Communications in the Swedish Premium Pension Scheme: extracts from the orange envelope

Statement of your premium pension (PPM) account: your investment funds

Fund holdings, 31 December 2004

Fund number	Name of fund	Distribution chosen (percent)	Number of shares in fund	Price per share (SEK)	Current value of investment (SEK)	Current distribution (percent)	Acquisition value (SEK)	Change in value (SEK)	Change in value (percent)
111 111	Real Interest Rate Fund	20	73.6526	143.24	10,550	25	9,928	622	6
222 222	Equity Fund America	20	19.2047	366.89	7,046	16	9,928	-2,882	-29
333 333	Equity Fund Sweden	20	14.0311	689.14	9,669	22	9,928	-259	-3
444 444	Equity Fund Europe	20	478.3054	15.99	7,648	18	9,928	-2,380	-23
555 555	Equity Fund Japan	20	157.2951	52.72	8,293	19	9,928	-1,635	-16
	Total fund investment, 31 December 2004				43,206*				

Change in value of your premium pension account from the beginning

Acquisition value (SEK)	Change in value (SEK)	Change in value (percent)	Current value (SEK)
49,640	-6,434	-13	43,206*

Note that the first contributions were invested in the Swedish scheme in 2000 at the equity market peak. In 2004 values (for those who invested early and in equities) show capital losses.

Estimate of your public pension

Provided below is an estimate of the pension that you will receive each month for the rest of your life starting when you retire. The estimate is based on the total credit that you have earned so far toward your public pension. The current amount of your pension credit – or the balance of your pension account – is shown in the box on page 2.

We have assumed that for each year until you retire you will have the same income and therefore earn the same pension credit as in 2003. Your pension credit for 2003 is shown on page 5.

If you begin withdrawing your public pension at the age of

61:	With 0 % growth, you will receive SEK 9,500 per month	With 2 % growth, you will receive SEK 14,500 per month
65:	With 0 % growth, you will receive SEK 12,000 per month	With 2 % growth, you will receive SEK 20,000 per month
70:	With 0 % growth, you will receive SEK 17,000 per month	With 2 % growth, you will receive SEK 31,300 per month

Your public pension, before taxes, at age 65 and with economic growth of 0% (SEK 12,000 per month) consists of SEK 9,800 in inkomstpension and SEK 2,200 in premium pension.

Note that the public pension here includes both the PAYG Notional Defined Contribution scheme "inkomstpension" and the pension which might arise from the PPM. Future returns on the PPM are (unrealistically) assumed to be the same as in the NDC scheme.

(ii) Integration of all pension information versus administrative complexity

For people to make well-informed decisions on rates of contribution and on asset allocation, they should ideally have information on all the pension rights/funds they have accrued, whether in the state pension system, the NPSS, or in private funds. As part of its "Informed Choice" programme the Government has therefore developed integrated pension statements which set out pensions already and prospectively earned under the different elements of the state system (BSP and S2P); it has regulated the flow of information from occupational and personal pension policy providers, and it has taken legal powers (not yet used) to require private providers to incorporate state pension information in Combined Pension Forecasts [Figure 10.20].

In designing the NPSS communications a trade-off will need to be made between comprehensiveness and operational complexity. Our tentative recommendations are that:

- NPSS reports should provide information both on account values (and prospective pensions) within the NPSS and on state PAYG pensions already accrued and likely to be accrued by a variety of future possible retirement dates.

- Whether it is feasible also to integrate data on other private pensions accrued (e.g. in particular in DB occupational schemes) should be considered once the system is in place and once any operational problems with the basic information flow are fully resolved.

(iii) Frequency of communication and branding

The optimal frequency of communication with members is linked to the issue (discussed in Section 6 above) of how frequently members can make asset allocation decisions. Cost considerations are important: so too is the issue of what frequency of information is most useful to members. More frequent communications will be valued by some members, but too frequent communication will result in NPSS account reports simply being ignored.

Further analysis and consultation should be conducted before making decisions on the frequency of communication, but the Pensions Commission's current judgement is that a high quality annual statement to each member is the key requirement. This reflects the following considerations:

- While some private occupational DC funds provide half-yearly or quarterly accounts, many work on an annual reporting basis, as do most personal pension policies.

Figure 10.20 Combined Pension Forecast

Combined Pension Forecasting (CPF), launched in October 2001, is a collaboration of the Department for Work and Pensions (DWP) with employers and pension providers, who participate on a voluntary basis.

Information in the CPF

State Pension Information

- Amount of Basic State Pension and Additional State Pension earned so far in today's prices.
- Projected amount in today's prices of Basic State Pension payable at State Pension Age if you pay or are credited with full National Insurance contributions from now until State Pension Age.

Occupational or personal pension information

- Compulsory annual benefit statement.
- An illustration of the pension (in today's prices) the member would be likely to receive at his/her normal retirement date.

Process and coverage of the CPF

Process

- DWP sends State Pension information to participating scheme/provider. It is then the scheme/provider which produces the Combined Pension Forecast.
- The vast majority of employers/providers participating in the service issue Combined Pension Forecasts annually.

Coverage

- By the end of August 2005 the DWP had supplied information for 4.47 million Combined Pension Forecasts and over 360 schemes were issuing or about to issue Combined Pension Forecasts.

Potential policy developments

Powers in the Pensions Act 2004 enable the government to compel schemes to co-operate in the production of Combined Pension Forecasts. This is a reserve power, which the Government can choose to use if it believes it the best way to meet its objectives.

- The existing state pension projections are done on an annual basis, and there would be no value in doing these more frequently. An integrated "state system plus NPSS" account can only usefully be provided once a year.

The design and branding of the account report will also be important. The Pensions Commission has found the Swedish "orange envelope" an interesting example to consider. By creating a strongly branded and nationally recognised communication, received by all citizens at the same time each year, the Swedish Government's Social Insurance Agency is able to foster a national debate around the adequacy of pension rights accumulated and the asset allocation choices that people have to make.

9. A scheme-specific tax regime?

In Chapter 7 Section 2 we reached the conclusion that, while in principle there might be good arguments for redesigning the current system of pension tax relief so as to redistribute the benefit to basic and lower-rate taxpayers, there is no practical way to do this in the foreseeable future, given in particular the complexities created by Defined Benefit schemes. The issue remains whether it would be possible and desirable to design a tax regime specifically for the NPSS.

Such a scheme specific tax regime could take the form illustrated in Figure 10.21. All members, whatever their marginal tax rate, would receive a government matching contribution set so that the scheme, relative to the existing system, would be value neutral for a basic rate tax payer. With no tax-free lump sum available the match could be equal to 42% of the employees' contribution (for someone contributing at the default level).

The key advantage of such a scheme would be the simplicity of the message. For every £1 the individual puts in, the government would contribute over 40p. With employer matching contributions in addition, the overall match would be over one-for-one. In addition:

- While tax-free lump sums would no longer be allowed, evidence on how much importance individuals attach to this feature is unclear [See Chapter 7]. And there is a good argument that since the aim of the NPSS is to ensure that people achieve a minimum of earnings replacement in retirement, 100% annuitisation would be preferable.

- Such a scheme would simplify the treatment of additional individual contributions to the NPSS, since tax relief credited would be independent of the individual's marginal tax rate[1].

Some disadvantages of the scheme also however need to be considered:

- The less favourable economics for higher-rate taxpayers might make it sensible for them to opt-out, and for their employer to make alternative arrangements within the existing tax regime, proliferating pension funds (e.g. for the individual who progressed from basic rate to higher-rate during their career) and adding administrative complexity for business.

- The impact on the cash-flow of public finances would be negative, even if the scheme were designed to be value neutral over the long-term. Extra tax relief would be given up front, while extra tax revenue (through the elimination of the tax-free lump sum) would flow later. (This might however be an appropriate offset to the decline of contracting-out rebates, which swells short-term government cash flow but which should not be devoted to current expenditure.)

[1] Contributions could still remain deductible in respect of the separately calculated tax credits however, maintaining the highly favourable treatment of those on the tapers of Working Tax Credit and Child Tax Credit.

Figure 10.21 Possible design of scheme-specific tax regime

Features:	No tax-free lump sum for NPSS funds (though taxable lump sums could still be allowed). Additional up-front tax relief given to compensate: for the basic rate tax payer this implies 37.2% up-front match on employee's contribution and 7% up-front match on employer's contribution. Net effect for a default level contributor is: if individual puts in £100 out of post-tax earnings, employer puts in £75, government puts in £42 match. Annuity income taxed at the individual's marginal tax rate as at present.
Implications:	Match is value neutral for the basic rate tax payer (and better than neutral for the 10% tax payer), but less attractive than the current system for the higher-rate tax payer. Therefore higher rate tax payer may be better advised to save outside the NPSS.

- The tax regime for pensions has just been changed significantly. There is a good case for stability for at least several years.

We have not reached a clear conclusion on the balance of these considerations. We are attracted by the idea of a simple "government match" approach, but we do not believe it is essential to the success of the NPSS. The pros and cons of introducing a scheme-specific regime should therefore be considered further, and should be a subject on which government should now consult.

In reviewing the issue, government should also consider whether there is any scope for introducing a matching scheme which is more favourable than the present regime, i.e. better than value neutral to basic rate or lower-rate tax paying NPSS members, and therefore entailing some net Exchequer cost. This option should be considered over time in the light of the overall cost of pension tax relief which may decline as the DB to DC shift continues and the aggregate contribution level falls.

If the decision was taken not to introduce a scheme-specific tax regime, it would be very important that information about the advantages of existing tax relief (and NI contribution reliefs for employers) was communicated more clearly to employees and employers.

10. Indicative operational costs: international experience

Low cost operation of the NPSS is essential. The potential to make pension saving possible at substantially lower AMCs is one of the key rationales for creating this national system. Chapter 1 Section 2 set out the argument that there is a segment of the market, which it is impossible profitably to serve except at AMCs (e.g. 1% and above) which are in themselves rational disincentives to saving and which substantially reduce the pensions achieved at retirement. It argued [see the panel at the end of Chapter 1] that the key to reducing costs was to eliminate high initial advice costs by compelling or auto-enrolling people into pension saving, and to reduce contract proliferation costs by creating individual accounts within a national scheme into which individuals could continue to make contributions as they moved through different employments. It also pointed out that one of the advantages of well-run PAYG systems is that they can achieve operational costs (as a percentage of the implicit value of the pension rights accrued) of as low as 0.1%.

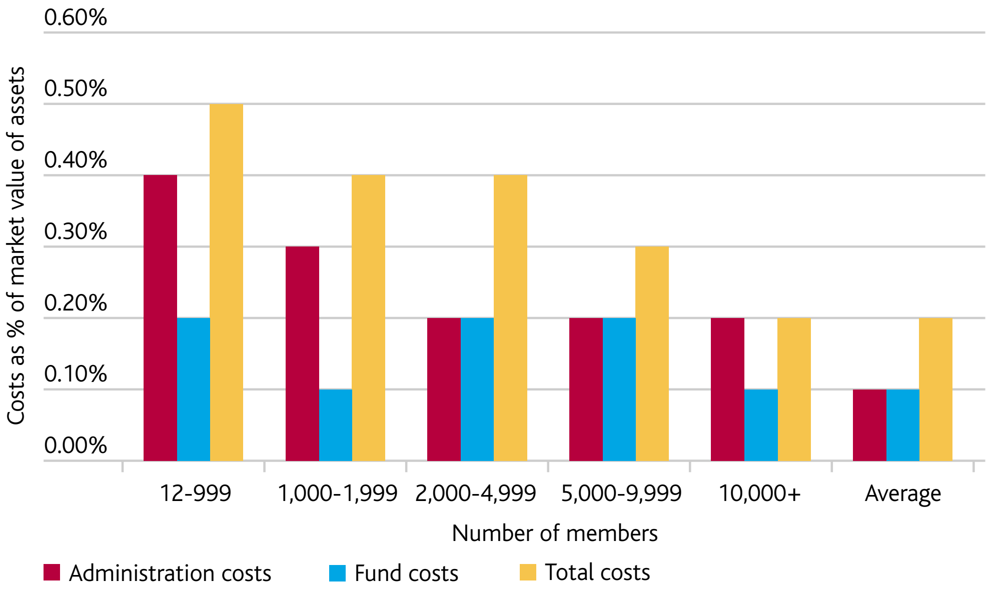
NPSS costs will necessarily be higher, but should still be substantially below 0.5%. The target we propose is 0.3%:

- It will not be possible to operate the NPSS at costs as low as a PAYG scheme. Auto-enrolment with the right to opt out is more complex than straight compulsion; freedom to choose between alternative funds will also add cost, so too will the need to pay investment management fees. Member communication will need to be more extensive than it has been in the past been within the PAYG system.

- But large occupational schemes face these complexities, and those with over 5000 members often operate with total costs at or below 0.3% [Figure 10.22].

Very large occupational scheme costs therefore represent a reasonable benchmark for the NPSS. During implementation planning, cost benchmarks should be designed for each element of the NPSS business system – payment system direct cost, account maintenance, fund management fees and communication with members. Best-practice benchmarks for the latter two will derive from large occupational schemes: payroll deduction costs need to be worked out in detail with HMRC or as a separate exercise if the option of a new Pension Payment System is pursued.

Figure 10.22 Occupational pension scheme costs according to the size of the scheme



Source: GAD survey of expenses of occupational pension schemes, 1998

Note: Each series has been rounded to the nearest 0.1% therefore numbers do not sum. The average is the weighted average of all members.

International experience provides some insight into the costs which might be achieved:

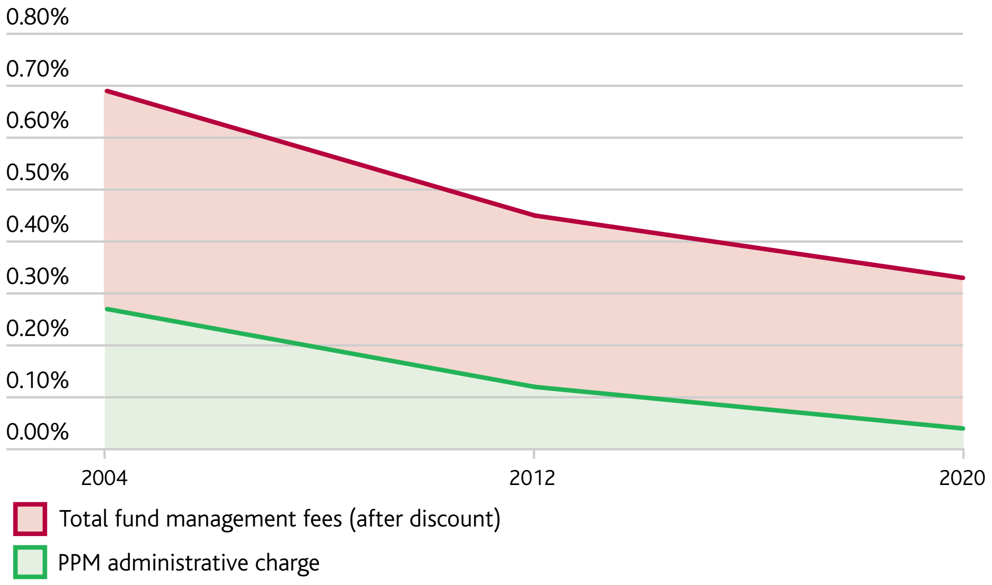
- The Swedish PPM currently has a total operating cost of about 0.22%, to which must be added about 0.42% fund management charges for those who choose to invest in non-default funds, but only 0.15% for the default fund, which the vast majority of new members are now selecting. Looking forward it is anticipated that total costs (operating plus fund management) for actively managed funds will be down to 0.33% by 2020, and that the total costs of investing via the default fund will be less than 0.2% [Figure 10.23]. We believe however that costs in the Swedish system have been unnecessarily increased by (i) failure to use the government's bulk buying power in fund management (outside the default fund) and (ii) unnecessary flexibility to make daily changes in asset allocation.

- The US Federal Thrift Savings Plan has a published operating cost of 0.06%, but we believe that this may exclude some costs arising elsewhere (e.g. payroll deduction and member enquiries) which are not explicitly allocated to the scheme. The President's Commission on Social Security Reform, drawing on the experience of the Federal Thrift Savings Plan, has suggested that total costs for "carved out" funds could be about 0.3%, even if the range of funds available is wider than in the Federal Thrift Savings Plan and includes actively managed funds.

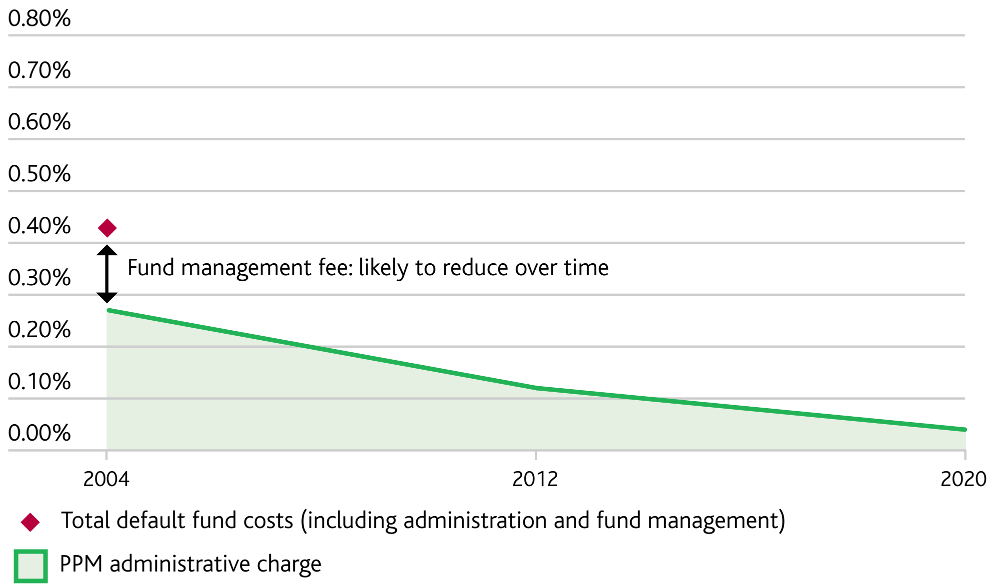
Further work is therefore required to establish reasonable cost targets. But the Pensions Commission believes that total costs of substantially below 0.5% per year should be achievable and that the target should be to achieve costs of 0.3% or less. Costs of 0.3% would significantly improve incentives to save for those segments of the market where pension under-provision is greatest.

Figure 10.23 Costs in the Swedish Premium Pension Scheme (PPM): current and planned

Costs in Swedish Premium Pension Scheme: non-default funds



Costs in Swedish Premium Pension Scheme: default funds



Source: Weaver 2004, information from PPM

11. A feasible implementation timescale

If the Pension Commission's recommendations are in principle accepted it will obviously be desirable to introduce the NPSS as soon as possible, alongside the reforms to the state system discussed in Chapter 9. It will be essential however that the launch of the NPSS is as smooth and fault-free as possible, and there are significant operational challenges to be met in launching a new system.

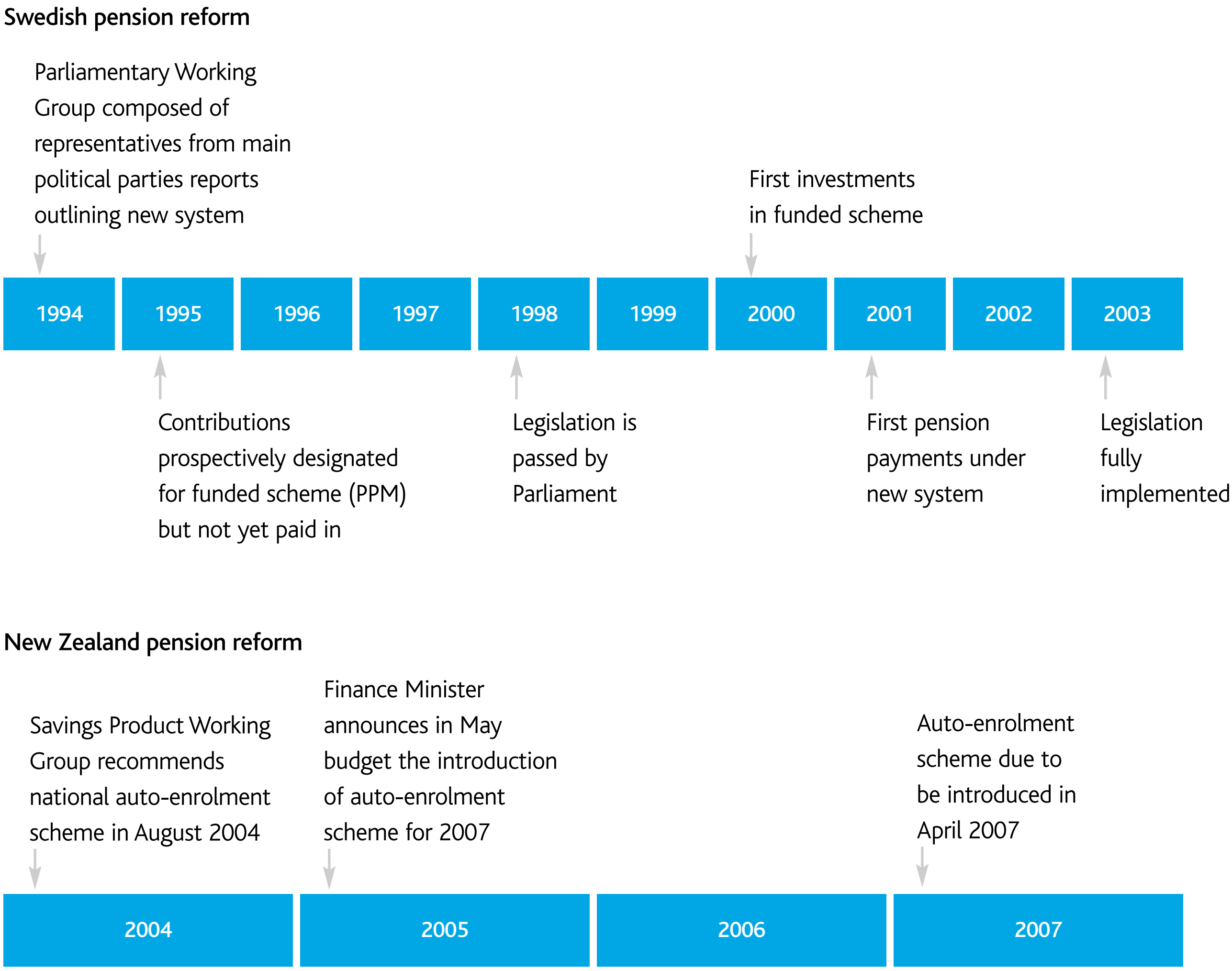
International experience provides only broad indications of timescales required for major pension reform [Figure 10.24]:

- In Sweden major pension reform, including the introduction of a national funded pension scheme with individual accounts and asset allocation choice (the PPM), took six years from the report of the working group to the first year of contributions into the funded scheme. In the Swedish case, however, the reforms included not only the introduction of the funded PPM, but the recasting of the state PAYG system into a NDC scheme. Since we are not recommending such radical changes to the core state system, a more rapid implementation ought to be possible.

- In New Zealand, the report of the Workplace Savings Product Group, which recommended the creation of a national auto-enrolment saving scheme, was followed only nine months later by a Budget commitment in principle, with implementation planned for just two years after that. There are suggestions, however, that this timescale may slip as some of the implementation challenges become apparent.

Further detailed work will be required to establish a feasible timescale. But the Pensions Commission believes that it is reasonable to plan on the assumption that the NPSS could be in place and receiving first contributions by 2010.

Figure 10.24 Introduction of pension reform in Sweden and New Zealand



12. Management and governance

High quality operational management will clearly be essential to the NPSS's success. So too will a governance structure, which provides assurance of independence. There are many details which will need to be determined, but the Pensions Commission's current thinking is that:

- The most appropriate institutional structure is likely to be that the NPSS is a non-departmental public body, with its own board. Within the range of possible structures, this is likely most effectively to balance: (i) the need for an institution which is clearly separate from direct government influence, particularly in its decisions on the range of investment fund choices; and (ii) the need for an institution which is clearly public and non profit-making [Figure 10.25].

- While the NPSS itself would be responsible for the overall integrity and effectiveness of the system, particular operational functions would be or could be outsourced:

  - If the PAYE option for the collection of contributions is chosen, payroll deduction and contribution accounting would effectively be outsourced to HMRC under clearly defined service agreements [see Section 3 above].

  - A range of options could exist for outsourcing member account maintenance and member communication functions. These should be assessed using normal criteria for choosing between in-house and outsourced operations.

- The most sensitive and judgemental decisions which the NPSS would need to make will relate to the range of investment fund choices made available, the procedures by which private fund managers would compete for mandates, the description of the risk return characteristics of different funds provided to scheme members, and the definition of the default fund. Key issues to be determined will therefore include how far these decisions should be constrained by legislation, and what governance arrangements should be put in place to ensure professional competence and integrity in the use of discretionary powers. The Pensions Commission's current but tentative thinking, is that:

  - Legislation should define fairly clearly the default fund and the government bond fund options, and should provide some general guidelines on the range of other funds to be made available, but leave significant latitude for detailed decisions.

Figure 10.25 National Pension Savings Scheme: Institutions

In implementing a new executive function, such as the NPSS, there are several options. These are summarised below:

Independence from Government

Institution	Example	Key Characteristics
Executive agency	■ Jobcentre Plus ■ National Savings and Investments	■ Directly responsible to Minister and Minister fully accountable to Parliament ■ No independent legal status ■ Staffed by civil servants
Non-Departmental Public Body (NDPB)	■ Pension Protection Fund ■ Student Loan Company	■ NDPB is directly responsible to Parliament for functions within its remit although Minister remains accountable for its continued existence and expenditure ■ Established under statute with own legal
identity		■ Allocated own budget ■ Not staffed by civil servants
Private tender company with contracted responsibility	■ Public private partnerships for schools and hospitals	■ Government out-sources function to private sector provider ■ Contract sets out respective liabilities and terms

– A dedicated Investment Funds Board may be required as a sub-committee of the main board of the NPSS, to allow detailed and expert consideration of issues relating to the range of appropriate funds.

– Appropriate reporting processes to Government and Parliament will need to be designed.

■ One possibility which should be considered is whether the NPSS should be housed within, amalgamated with, or linked with the already existing National Savings and Investments (NS&I). The advantage would be that "National Savings" is an extremely well-respected brand, and that the NS&I organisation already exists, operating retail savings accounts within the public sector but with significant commercial expertise. We have not investigated this option in detail, and there may be reasons why on further analysis it is inappropriate, but we recommend that the possibility of a role for the NS&I brand and organisation should be explored during the implementation planning phase.