PENSION NOTES

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AUTOMATIC ENROLLMENT FOR COMPLEMENTING PENSIONS: THE SUCCESSFUL CASE OF THE UNITED KINGDOM

Executive Summary

One of the policies that some countries have applied to alleviate the ailing finances of their public PAYGO systems and raise the replacement rates that workers can access after a lifetime of work, is the incentive to save for retirement in individually funded private pension plans, through an automatic enrollment mechanism.

This mechanism incorporates the findings of behavioral economics, which indicate that many people need to be "nudged" to save, since human behavior is based on inertia. Automatic enrollment is precisely the necessary nudge to get workers to save, since it prevents them from having to make the decision to enroll, and makes it easier for them to save longer. If they are included in a savings system by default, workers tend to stay there, since they have to make an active and pondered decision to stop saving in order to opt out.

The case of the United Kingdom is emblematic, since it was the first country to massively include a mechanism of this type in its pension system to improve pension savings levels. The mandatory minimum contribution to this system has been 8% of the total wage since April 2019 (3% paid by the employer, 4% by the worker and 1% by the State).

More than 10 million workers have been automatically enrolled as of June, 2020, contrasting with only one million automatically enrolled in June 2013. The system has also generated an increase in the participation of workers who are eligible for the occupational pension system (corporate), from 10.7 million workers in 2012 to 19.2 million in 2019. The managed value of all contributions made on behalf of workers eligible for this program, in turn, has steadily increased from GBP 73.6 billion in 2012 to a total of GBP 98.4 billion in 2019.

It must be emphasized that this system has ensured that 91% of those who are automatically enrolled remain in the system. Only 9% of workers enrolled by default have opted out.

Results in the UK have been especially relevant and meaningful among low-income and part-time workers, women and young people. Until 2012, only large corporation and public sector employees were enrolled in occupational pension systems and had retirement savings in the United Kingdom. The system has ensured that employees of small and mid-sized enterprise (SMEs), and those with lower wages, also save for their retirement.

In the light of the experience of the United Kingdom, it would be particularly relevant for the automatic enrollment mechanism to be adopted as part of the design of the pension systems in Latin America and other regions with low pension coverage. This would enable increasing workers' retirement savings levels, promoting a savings culture, and creating a pension system for self-employed workers who have not invested for their retirement in any way.

Introduction

The evidence shows that countries with PAYGO systems in different parts of the world have begun to adopt mechanisms to increase savings through private, complementary individually funded pension plans, in order to alleviate the fiscal deficits faced by public systems and improve the overall replacement rates obtained by workers. An example of this type of mechanism is the automatic enrollment (AE) system in the United Kingdom, in place since 2012, which requires employers to automatically enroll all employees who meet certain requirements in some type of pension plan or instrument.

This pension note explains the reasons that gave rise to this system in the United Kingdom, its main operating characteristics and the facts that demonstrate its success.

Reasons that gave rise to the AE system and its objectives

The AE system in the UK is based on proposals put forward by the Government-appointed Pensions Commission in 2002. The Pensions Commission materialized its work in two reports, one in 2004[1] focused on the diagnosis of the status of the UK Pension System, and another one in 2005 (Turner Report[2]) which presented the proposed solutions and recommendations.

The Commission's first report identified three major trends in the UK pension system.

(i) 46% of the private sector workforce was entirely dependent on the state's public pension in 1995. This percentage of workers had increased to 54% by 2004. This powerfully illustrated the decline in private pensions and the degree of responsibility under which the public pension system should operate.
(ii) Only 0.5% of the workforce actively made rational saving decisions, considering aspects such as risk/return, management costs, the service provided and the value of their pension assets. Workers only enrolled in pension systems if they were mandatorily enrolled in an occupational pension system by public services or the companies they worked for, or if a pension products provider (for example, an insurance company) approached them to sell them a pension instrument.
(iii) It was impossible for small and mid-sized companies to offer occupational pension plans to their employees, without avoiding such high management and administration expenses that they ended up reducing the final retirement funds of workers.

The conclusions of the second report (Turner Report) on the status of the UK pension system pointed out that the benefits of the public and individually funded private pension systems were going to be increasingly inadequate and unequal. It was deemed that the problems could not be solved by merely making changes in the Public Pension System, or increasing measures for encouraging voluntary savings. In this context, saving through the purchase of houses and the inheritance of real estate assets would be an adequate additional contribution to retirement income, but could not be considered a suitable answer. Long-term pension policy needed to be robust to face the increase in life expectancy and greater uncertainty regarding the pace of this increase.

Thus, the proposal arose to apply an AE model to retirement savings systems at the national and occupational pension plan levels, promoted individually by the employer. The Government undertook to abide by the main proposals of the Pensions Commission, hence the 2008 Pensions Act introduced the measures for implementing the AE system, making them a necessary complement to the public pension, aimed at ensuring that the total pensions that workers receive on retirement are adequate and contribute to the sustainability of the British public pension system.

According to the calculations of the Pension Commission, the target replacement rate for people with a median salary to access an

[1] "Pensions: Challenges and Choices."
[2] "A New Pension Settlement for the Twenty-First Century."

adequate pension, should be between 60% and 66% of the last salary prior to retirement. Between 15% and 18% of this target replacement rate would come from the mandatory minimum contributions to the AE system (by employers, workers and the State). Another 15% to 18% would be achieved with the additional voluntary contributions that workers and/or employers pay into the system. Hence, adding the minimum mandatory and voluntary contributions, between 30% to 36% of the total pension replacement rate of the last salary would come from the savings generated by the AE system (i.e., 50% % or more of the total target replacement rate).

Keys to the functioning of the automatic enrollment system (AE)

The case of the United Kingdom is a benchmark of success, since it contributes to savings and improves the retirement income of millions of people in that country. According to Martínez-Cue (2019), the keys to the functioning of the AE system are mainly as follows:

1. **The model is based on behavioral economics studies.** The AE model is based on the behavioral economics research of Professor Richard H. Thaler (2017 Nobel Laureate in Economics), in which he concludes that most citizens have the will to save, but do not take the measures to do so. Nonetheless, if they are included by default in a savings system, they tend to stay, since they would have to make an active and pondered decision to stop saving, in order to opt out. Behavioral economics found that people often do not make rational decisions when it comes to deciding on how to spend or save money. This is because:

   - They find it difficult to imagine themselves in the long term: they do not reflectively envision their future.
   - They prefer and choose short-term over medium and long-term rewards.

   Even though workers know that enrolling and participating in their employers' retirement systems is in the best interests of their future well-being, many do not do so. People, therefore, need to be nudged to make decisions that are beneficial to their interests. AEs provide this "nudge" by automatically enrolling workers and making it easier for them to save longer.

2. **Matching contribution.** Another characteristic of the AE model in the United Kingdom that has led to its success, has been the inclusion of a parallel contribution mechanism, or a "conditional subsidy," in which workers must mandatorily contribute to be entitled to the employer's contribution. When workers perceive that the employer makes an economic effort and compensates them with a contribution to their pension fund, which represents a benefit in addition to their wages, it encourages them to commit to remaining enrolled in the pension system and making their own contributions. The result is that workers are more appreciative of the benefit of being participants in a pension system, thus facilitating their commitment to retirement saving.

3. **Option of money management through public trusts.** There is a public savings trust in the UK (called NEST, *National Employment Saving Trust*)[3] which centralizes savings and outsources money management to several international firms. NEST functions as a corporate pension trust established by the government to support the AE system, offering: (i) free services for companies; (ii) high quality investment services; and iii) low cost to members.

4. **Mandatory for employers and voluntary for workers.** Employers are obligated to enroll all workers who meet certain

[3] Regulated by the Pension Law of 2008 to support the implementation of AE. It was established in 2010, and began operating for voluntary pension agreements in 2011, while awaiting the start of mandatory AE implementation as of 2012.

minimum requirements in an occupational pension system, and to make minimum contributions in their favor, provided that the workers also contribute the corresponding percentage. Thus, two groups of workers are defined:

- **Workers entitled to AE.** In order to be "eligible workers," employees must be between 22 and the official minimum retirement age (66 for men and women, as of October 2020). They must also receive "qualifying income" above a minimum limit, set at GBP 10,000 per year (approx. USD 12,776) for the 2019-2020 period.
- **Ineligible workers.** Although they are not entitled to AE in the company's plans, they can request to be enrolled and receive the mandatory contribution from the employer. They include employees between the ages of 16 and 21, or those between the official retirement age and 74 and those with income equal to or less than the aforementioned legal limit of GBP 10,000 per year (approx. USD 12,776).

5. **Right to *opt-out* and re-enrollment obligation.** Workers who have been automatically enrolled can choose to opt out up to one month from the day they are officially enrolled in a corporate pension plan. If an employee who has chosen to opt-out subsequently wishes to return, he may do so at least once every 12 months. The employer will have to accept his subsequent enrolment request and contribute in his favor if he continues to meet the requirements.

   If the worker chooses to opt out for a second time (or stop paying his contributions) and subsequently reapplies for enrolment after another 12 months, the employer shall not be obligated to accept him, but may do so.

   Every three years, employers must automatically re-enroll all workers who meet the requirements and who are not enrolled. This practice is called "*re-enrollment* and includes workers who have chosen to opt out on more than one occasion.

6. **Minimum contributions**. The mandatory minimum contribution has been 8% of the total salary since April, 2019, distributed as follows: 3% paid by the employer, 4% by the worker, and 1% by the State (through tax deductions by the Government, directly paid into the Pension System). The total contribution was lower prior to that date, as can be seen in Table 1.

Table 1. Evolution of contributions to the AE system in the United Kingdom

Date	Employer	Worker	State	Total
Oct. 1, 2012 - Mar. 2018	1%	0.8%	0.2%	2%
Apr 1 2018 - Mar. 31 2019	2%	2.4%	0.6%	5%
From Apr. 1 2019	3%	4%	1%	8%

Source: Martínez-Cue (2019).

7. **Workers' freedom to choose the investment option of their contributions**. The AE system allows employees to choose the investment option of their contributions, and those that their employer and the State make in their favor, being entitled to:

    - Choose from a range of investment options, some of which are "low cost" (typically passively managed, with replicating indices).
    - If they fail to make any decision regarding the investment option, they are included in a default fund.

    Default funds and portfolios usually have a conservative or moderate investment strategy (with high exposure to fixed-income assets), although they are rarely guaranteed.

    A significant number of the default funds and portfolios are life cycle (generational) funds, known as Target Date Funds, TDFs). In these investment strategies, there is a greater weighting of investment in variable income assets at the beginning of the worker's professional career (with higher return possibilities, but with greater risk). As the worker approaches retirement age, the allocation to risky assets is progressively reduced and investment in fixed income or other less risky assets increases.

8. **Limited management costs.** Any commission that the employer charges on the EA system has a legally established management expense limit (including two concepts: instrument management and investment management) of 0.75% per annum on managed assets.[4] (prior to the AE-based reform, the costs of managing a pension plan for small companies amounted to between 1.5% and 2% per year, which according to estimates by the British Ministry of Work and Pensions, could reduce the amount of workers' pensions by more than 30%).

    Table 2 shows the average management expenses actually applied after the AE reform (in 2017), according to the pension instrument used. In all cases, this expense is less than the established maximum limit, which can be explained by the economies of scale achieved by the AE system. This significantly helps to facilitate savings for low-income workers and SMEs, preventing management expenses from consuming a significant part of the returns and accumulated retirement assets.

[4] The so-called transaction costs are excluded from this limit: those third-party costs generated when investments are bought or sold in organized markets (costs associated with the realization value of the assets in which the consolidated rights of the participating workers are invested).

Table 2. Average management expenses according to type of AE instrument used in the United Kingdom in 2017 (annual % of assets under management)

Self-Employment Pension Plan (Sole Employer) (1)	Group Personal Pension Plan offered by Insurance Company (2)	Employment Pension Plan (Multi-employer) (3)	Pension plan offered by NEST (4)
0.38%	0.54%	0.48%	0.3%

Source: Martínez-Cue (2019) in the case of (1), (2) and (3). In the case of (4), the pension plan offered by NEST, the source of information is: https://www.nestpensions.org.uk/schemeweb/nest/aboutnest/nest-charges.html. In the latter case, one must add that there is a cost of 1.8% of new contributions, plus transaction costs that are discounted from the returns on investments.

9. **Tax benefits.** Contributions to pension funds are tax exempt. The income generated is also exempt during the accumulation period. However, there is an obligation to pay taxes on most of the benefits paid.

Why is the AE program considered successful?

The AE program in the UK has been a resounding success, explained by the following facts:

1. **The model had a State commitment and the agreement of all the actors involved: government, parliament, businessmen and workers' unions.** All interest groups had to negotiate and compromise their positions, to achieve a greater common good:

   - The business associations had to accept the fact that contributions were mandatory, and therefore accept an increase in their costs. This costs increase would have also occurred if, instead of approving the implementation of the default AE, the decisions to reform the British pension system had taken other alternatively proposed routes to achieve the necessary increase in the system's revenue (such as the increase in employers' contributions to the public pension system or the creation of new corporate taxes).

   - The trade unions had to accept the fact that workers also had to contribute a part of their salary for the company to be obligated to contribute. They also accepted the increase in the official retirement age.

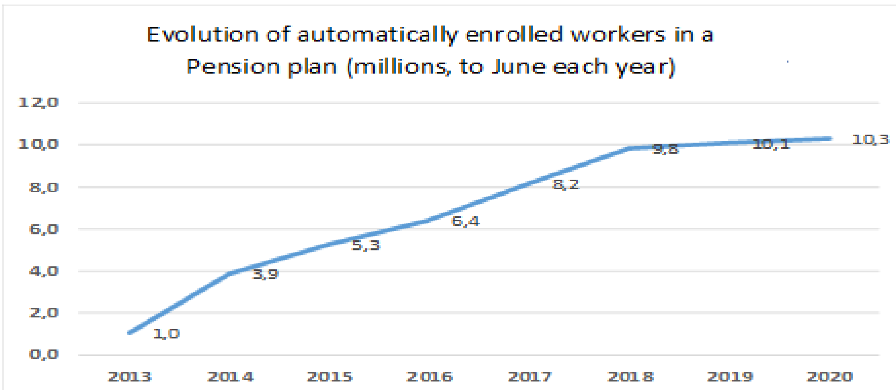
   - The government also supported the measure with incentives (tax deduction and state matching contribution*)*, which is also considered a contribution to the system. The government also waived a tax hike.

Key to this result was the work of the Pensions Commission, which, by means of thorough technical rigor and analysis, put the facts, data and diagnosis on the UK pension system on the table, together with a rigorous proposal of recommendations for reforms, which were open to debate. Secondly, this Commission had a remarkable capacity to promote the agreement, depoliticize the pension issue, and involve all stakeholders.

The above is very important, because when analyzing the reforms of pension systems in other countries, the ability to negotiate and compromise to reach agreements (for the common good) is a common characteristic in successful reforms of pension systems.

2. **<u>There was significant growth in automatic enrolment</u>.** As can be seen in Graph 1, more than 10 million workers were automatically enrolled as of June, 2020, representing a significant increase compared to the one million enrolled workers in June. 2013.

Graph 1



Source: FIAP, based on UK Pension Regulator (TPR) data. Information available at: https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/automatic-enrolment-declaration-of-compliance-report

3. **<u>It has generated an increase in the participation of eligible workers enrolled in corporate occupational pension systems.</u>** Between 2006 and 2012, prior to the implementation of the AE, there was a significant drop in the participation of these eligible workers, from 62% of total eligible workers (12 million) in 2006, to 55% (10.7 million) in 2012. This trend was reversed as of 2012, as a result of the AE-based reform. According to the latest information published by the British Ministry of Work and Pensions (DWP[5]) Since then there has been a significant increase in eligible workers participating in the occupational pension system, increasing to 88% in 2019 (19.2 million workers), which is 33 percentage points higher than in 2012.

4. **<u>It has resulted in a significant increase in the managed value of the total contributions made in favor of eligible workers[6]</u>.** As can be seen in Graph 2, the annual contribution in favor of workers eligible for AE in 2019 amounted to a total of GBP 98.4 billion, GBP 21.3 billion more than in 2012.

[5]Source: https://www.gov.uk/government/statistics/workplace-pensions-participation-and-savings-trends-2009-to-2019

[6] This is the total managed value of all the contribution flows made in favor of workers eligible for AE (i.e. it considers the value of contributions from workers, employers and the State).

Graph 2

Evolution of annual contributions of all workers to Occupational pension plans: 2008-2019 (billions of GBP)

Source: FIAP, based on Martínez-Cue (2019) and data from the British Ministry of Work and Pensions (DWP) for the year 2019. Data available at: "Workplace pensions participation and savings trends: 2009 to 2019"

5. **<u>Only 9% of automatically enrolled workers have opted out of the program.</u>** This means, therefore, that 91% of workers enrolled by default have remained in the AE system. This goes to show that when workers are 'nudged' to save, and the system's design contains the right incentives (as is the case in the UK), workers do not stop saving and opt out, even though they have the opportunity to do so. It is also noteworthy that the surveys show that 5% of all workers who are not eligible for automatic enrollment, but who can voluntary opt in, do so.

6. **<u>The rate of participation in the occupational pension programs of the youngest workers, women and lower-income workers, has especially improved.</u>** Until 2012, only workers employed by large corporations and the public sector in the UK were enrolled in occupational pension systems and had retirement savings. The AE system has made it possible for workers in small and medium-sized enterprises (SMEs), and those with low wages, to save for retirement as well. As can be seen in Table 3, the AE program has increased the participation of young people between 22 and 29 years of age by 60%. The rate of participation among women, in turn, has increased by 45%, thus equaling the participation rate for men (85%). The program also had a particular impact on the savings of lower-income workers, many of whom have started saving for retirement for the first time.

Table 3: Comparative data on participation rates in occupational pension systems by groups: 2012 (before AE started) versus 2018

By Age	2012	2018	**Increase in percentage points**
Youth 22-29	24%	84%	60%.
Over 50	50%	85%	35%
By sex			
Women	40%	85%	45%
By wage level			
Between GBP 10,000 and GBP 19,999	20%	88%	59%
Above GBP 50,000	n.a.	93%	n.a.

Source: Martínez-Cue (2019).

7. **The largest program created to support AE, NEST (see point 3 of the previous section), has had very positive results over time.** At the end of October 2012, there were only about 2,000 workers enrolled by 175 employers, with minimal assets under management, whereas, to June 2020, it already had a total of 9.2 million workers enrolled by more than 800 thousand employers, and total assets under management of approximately GBP 11.7 billion (approx. USD 14.948 billion)[7].

[7] Source: Nest Quarterly Investment Report, June 2020

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