

2008 Smaller Firms Pension Survey Report... 1

Launch of personal accounts likely to lead to widespread review of pensions in smaller firms: majority say existing schemes will fail exemption test



The heat from personal accounts may melt away existing smaller schemes

personal accounts and auto-enrolment may boost pension coverage, but the reforms are likely to cause levelling-down and closures of many schemes: open defined benefit schemes are already close to extinction in the sector

The Association of Consulting Actuaries' (ACA) latest *2008 Smaller Firms Pension Survey* was conducted in June and July of this year. Over 390 firms, all with 250 or fewer employees, responded to a wide range of topical questions, including a special section on the Government's personal accounts and auto-enrolment reforms. This first report on the results focuses on the trends evident from the survey and, in particular, attitudes towards the Government's latest reforms.

Some of the main findings of the survey are

detailed below. They paint a picture of a sector where workplace pension coverage is still extremely weak. Whilst the majority of firms responding to the survey run some sort of pension scheme, they represent the most pension-positive side of the sector. The reality is that the vast majority – around 80 per cent¹ – of the UK's 1.2 million smaller firms, who employ over 9 million employees, run no workplace pension arrangements at all. All of these firms will have to come to terms with personal accounts and auto-enrolment, at present by 2012, including the costs and administration involved, albeit that there will

be some phasing in of the reforms.

The survey underscores the 'under-pensioned' position of employees in smaller firms (and hence their current dependence on State provision and the justification for the personal accounts initiative). However, the survey also found that for very many of these smaller firms running an existing scheme, auto-enrolment and the launch of personal accounts are likely to lead to reviews of many of the present pension arrangements that have been established, leading onto adjustments and reductions to benefits and to scheme closures.

the key findings

majority of existing schemes would fail personal accounts exemption test

55% of firms say their current pension schemes would fail the personal accounts exemption test, with over 60% paying lower contributions than proposed for personal accounts.

opt outs from personal accounts are expected to be high

the smallest firms with an existing scheme or with no scheme expect opt out levels by individual employees to exceed 40%. Affordability is seen as the principal reason likely to drive opt out decisions, not the loss of means-tested benefits in retirement.

one-third of firms say they will level-down

31% of firms expect to reduce their pension scheme benefits (to mitigate the cost of higher membership) or to close their scheme in favour of personal accounts.

open defined benefit schemes all but gone from sector

over 90% of the defined benefit schemes in the sample are closed to new entrants with half closed to future accruals.

¹ *Security in Retirement: towards a new pensions system* published by DWP, May 2006, page 74

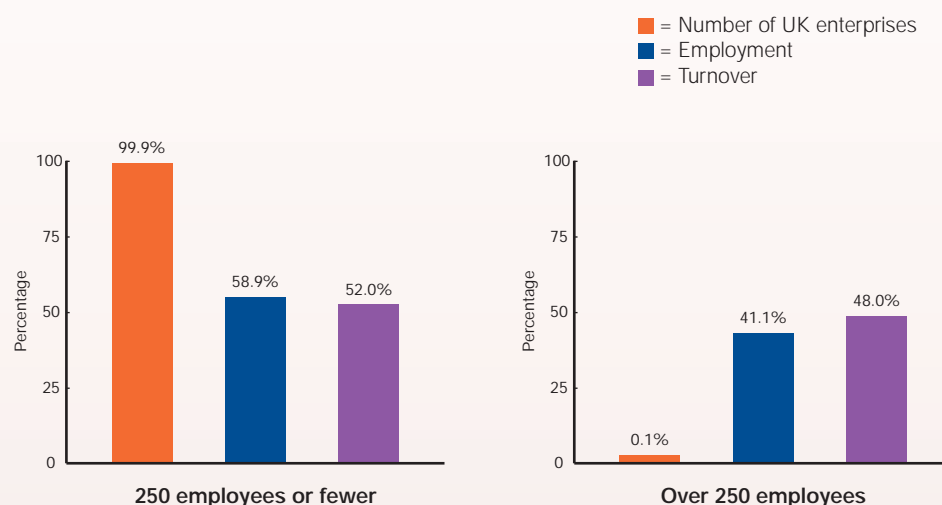
facts and figures: smaller firms sector dominates UK economy

The smaller firms sector - firms employing 250 or fewer employees - is the largest part of the UK private sector economy. It employs over 59% of the working population and generates over half of the UK's business turnover of £2.7 billion (BERR figures: July 2008).

These smaller firms make up over 99% of UK enterprises - there are only 5,900 businesses including public corporations and nationalised bodies - that now employ over 250 people. The importance of pension trends in the smaller firms sector is therefore clear in terms of the coverage of employees - over 9 million - and the potential of some of these firms to be the larger firms of the future. It is also the key market where the success of the new personal accounts scheme and auto-enrolment will be most tested, including as it does over 1.2 million firms, the vast majority of which at present operate no workplace pension scheme.

The major test for the Personal Accounts Delivery Authority (PADA) and its appointees over the next 3 to 4 years will be to establish a sound personal accounts administration system to capture data on

Figure 1: Share of enterprises, employment and turnover by size of business



(Source: Small and Medium-sized Enterprises Statistics, published by Department for Business Enterprise & Regulatory Reform, 30 July 2008)

over 1.2 million firms (the vast majority with fewer than 4 employees) that is also able to cope with the dynamic changes in business numbers (over 15,000 per year), the movements of employees from firm to

firm and changes in opt out decisions, and - of course - pension investments! This is an extremely challenging task with an even more exacting timetable.

Figure 2: Over a million employers: the personal accounts challenge

UK Private sector firms	Number of Enterprises	Employment (thousands)	Average number of Employees per firm
Small firms			
1 - 9 employees	1,019,295	3,764	4
10 - 49 employees	166,815	3,265	20
50 - 249 employees	26,690	2,653	99
Total: smaller firms (under 250)	1,212,800	9,682	8
250 or more employees	5,915	9,279	1,569
Total: all firms with employees	1,218,715	18,961	16

(Source: Small and Medium-sized Enterprises Statistics published by Department for Business Enterprise & Regulatory Reform, 30 July 2008)

background to survey: existing pension provision falling short

This is the sixth *Smaller Firms Pensions Survey* the ACA has conducted since 1996. The survey attracted 394 responses from firms to a questionnaire issued in June 2008. Of those responding to the survey:

- just under a half employ 50 people or fewer (which is a higher proportion than in earlier biennial surveys), around one-third employ between 51 - 150 employees and just under a fifth employ between 151 to 250 employees.
- the firms covered by the survey are active across a wide range of sectors, with the largest being business services, retail, logistics/transport, manufacturing, hi-tech, print/publishing, construction and financial services.

Whilst the majority of firms responding to this survey offer pension schemes,

employees in smaller firms are not generally well covered by pension arrangements. And, where pensions are provided, take up is often poor (45% in this survey, overall). Altogether, we estimate that there are at present around 6.6 million private sector employees saving in work-based schemes, 3.6 million in traditional trust based defined benefit (2.7 million) and defined contribution schemes (0.9 million), with a further 3 million in Group Personal Pensions and Stakeholders (although the latter figures are far from certain). This leaves over 12 million private sector employees reliant on individual personal pensions (perhaps 2 million) to boost their retirement income or solely reliant on the State pensions.

It is these numbers that drove the Pensions Commission and then the Government towards both auto-enrolment (where employees are opted into a work-

based scheme and have to positively opt-out) and the launch of personal accounts – a work based and centrally administered scheme for employees in firms that do not offer an exempt employer-sponsored scheme (i.e. a scheme at least equivalent to personal accounts).

Firms responding to this ACA survey predominantly rely on Group Personal Pension (GPP) and Stakeholder offerings. Under a sixth of the generally larger firms in the sector offer defined benefit schemes, but of these 91% are now closed to new entrants and 48% are closed to future accruals. Given the current economic position and the failure of reforms to significantly reduce the costs involved in running such schemes, it would be surprising if by 2012 more than a handful of defined benefit schemes in the sector will be left open.

Figure 3: Main types of pension arrangements offered by respondents

Type of pension scheme	Percentage of firms with type of schemes	Percentage closed to new entrants	Percentage also closed to future accruals	Average scheme membership (of eligible employees)
Group stakeholder scheme	48%			24%
Group personal pension scheme	44%	4%		56%
Defined benefit scheme	16%	91%	48%	65%
Trust based defined contribution scheme	13%	30%		58%
Mixed defined benefit / defined contribution	5%			62%

The survey, echoing our 2006 survey results, also found evidence of closures of trust-based defined contribution schemes in favour of lower-cost Group Personal

Pensions and Group Stakeholder plans, where contribution levels and membership participation are often lower, as are regulatory burdens. This is a worrying

levelling-down in a sector where provision is already weak, ahead of any impact from personal accounts.

why pensions: why not?

Firms that offer pension schemes in the sector generally do so because they believe it helps build their image as a caring employer, motivating and encouraging loyalty from employees. Smaller firms, however (under 50 employees), are more likely to say the Stakeholder rules, introduced in 2001, forced them to establish a scheme. Large firms (151-250 employees) place greater emphasis on the importance of their pension package in enabling them to attract skilled staff in a competitive environment.

Firms that do not offer workplace pension schemes placed 'cost' as the key reason why not, ahead of employees' preference for non-pension benefits.

The reasons are similar when firms are asked why individuals do not join existing schemes, where these are available.

Affordability rides high in both lists and draws into question whether pension take-up can be materially improved in the near-term, particularly if economic conditions are not good at the time the latest reforms are to be implemented in 2012. Undoubtedly, personal accounts and auto-enrolment more generally could be more easily

Figure 4A: 'Top 3' reasons why firms do not provide a pension scheme and / or an employer's contribution to a stakeholder scheme

Ranked order	
1	Cost – cannot afford employer contributions
2	Employees prefer non-pension benefits
3	Scheme inappropriate due to staff turnover

Figure 4B: 'Top 3' reasons why firms think individuals do not join the firms' existing pension scheme

Ranked order	
1	Prefer to spend income
2	Cost – cannot afford
3	Lack of interest

introduced if their implementation coincides with reductions in both corporate and personal tax levels, particularly if there were

incentives to help smaller firms and individuals on lower to mid-income levels.

pension contributions: few signs of much needed increases

With the exception of defined benefit schemes, where average combined employer and employee contributions have

increased over the last few years to around 25% of earnings, most of the individuals in open defined contribution schemes in the

sector are receiving combined employer and employee contributions ranging between 5 - 10% of earnings.

Figure 5: Average of contributions paid into pension schemes (as a percentage of total earnings)

Average employer contributions					
	2005	2006	2007	2008	Longer term
Defined benefit scheme	15.6%	17.7%	19.5%	19.0%	16.0%
Defined contribution scheme	6.0%	6.1%	5.4%	5.5%	NA
Group Personal Pension	5.4%	5.5%	4.7%	4.7%	NA
Stakeholder scheme	3.2%	3.3%	2.0%* (4.3%)	2.0%* (4.3%)	NA

Average employee contributions					
	2005	2006	2007	2008	Longer term
Defined benefit scheme	5.8%	6.1%	6.0%	6.0%	6.5%
Defined contribution scheme	4.1%	4.2%	4.2%	4.3%	NA
Group Personal Pension	3.2%	3.7%	3.9%	3.9%	NA
Stakeholder scheme	3.1%	3.1%	3.0%	3.1%	NA

Average combined employer and employee contributions					
	2005	2006	2007	2008	Longer term
Defined benefit scheme	21.4%	23.8%	25.5%	25.0%	22.5%
Defined contribution scheme	10.1%	10.3%	9.6%	9.8%	NA
Group Personal Pension	8.6%	9.2%	8.6%	8.6%	NA
Stakeholder scheme	6.3%	6.4%	5.0%* (7.3%)	5.1%* (7.4%)	NA

(Note: * Figure is average, including 54% of employers who pay 'nil' contribution. Figure in brackets is average of those schemes where employers pay a contribution. Sources: ACA 2006 and 2008 Smaller Firms Survey.)

The higher incidence of smaller schemes in this year's sample compared to 2006 probably explains the marginally lower levels of contributions into defined contribution schemes registered this year. As a result, the combined contributions are on average not greatly above the proposed personal accounts minimum levels. This is likely to explain why so many smaller firms, as indicated elsewhere in the survey, rate their own scheme as not being adequate to secure exemption from personal accounts. Presently, the smallest firms (with up to 50 staff) on average report combined contribution levels for all types of defined contribution schemes at markedly below

the personal accounts minimum levels.

The increase in defined benefit contributions, which will be covered in greater detail in *Report 2* of this survey in the autumn, reflects both strategies to reduce past service deficits under the watchful eye of the Pensions Regulator, but also increases to meet the rising cost of future accrual, not least because of improvements in longevity. The fact that schemes are closed and their remaining members are ageing will also have contributed to the increase.

The survey found Stakeholder pension

contributions on average falling below 8% of earnings, with still many schemes (54% in our sample) receiving no employer contribution and thereby falling well below the personal accounts minimum contribution levels. The Government estimates there are some 2 million employees in work-based schemes where presently the employer contribution is below 3%. From 2012, these employees could potentially have their employer contribution into an existing scheme increased or adjusted to 3% of band earnings, applied over the 3-year phasing in period. Or, they could find their present scheme abandoned in favour of personal accounts.

Figure 6: 2008 defined contribution levels broken down by firms' size

Average employer contributions	1 – 50 employees	51 – 150 employees	151 – 250 employees	All
Defined contribution	4.5%	5.2%	6.0%	5.5%
Group Personal Pension	3.9%	4.7%	5.5%	4.7%
Group Stakeholder scheme	1.7%* (4.0%)	2.2%* (4.5%)	3.2%* (5.0%)	2.0%* (4.3%)

Average employee contributions	1 – 50 employees	51 – 150 employees	151 – 250 employees	All
Defined contribution	3.2%	4.0%	4.7%	4.3%
Group Personal Pension	3.0%	4.1%	4.3%	3.9%
Group Stakeholder scheme	3.0%	3.2%	3.8%	3.1%

Average combined contributions	1 – 50 employees	51 – 150 employees	151 – 250 employees	All
Defined contribution	7.7%	9.2%	10.7%	9.8%
Group Personal Pension	6.9%	8.8%	9.8%	8.6%
Group Stakeholder scheme	4.7%* (7.0%)	5.4%* (7.7%)	7.0%* (8.8%)	5.1%* (7.4%)

(Note: * Figure is average, including 54% of employers who pay 'nil' contribution. Figure in brackets is average of those schemes where employers pay a contribution. Source: ACA 2008 Smaller Firms Survey.)

If personal accounts or auto-enrolment into existing schemes encourages a higher level of participation, then the pension costs of many smaller firms will increase and, in many cases, quite markedly over the three year phasing in period. Depending on the expected degree of higher participation by employees, existing schemes - as we note elsewhere - may be revised, confined to selected employees or may be abandoned

altogether. In reality, firms will have to make decisions about scheme redesign in advance of employees choosing whether or not to participate in the new arrangements; they will tend to be cautious in anticipating new participation rates.

For society as a whole, the even more challenging dilemma is how we increase average pension/ savings rates to much

higher levels – ideally closer to 15% of earnings – given the current cost-pressures, particularly on lower and mid-income groups and smaller firms.

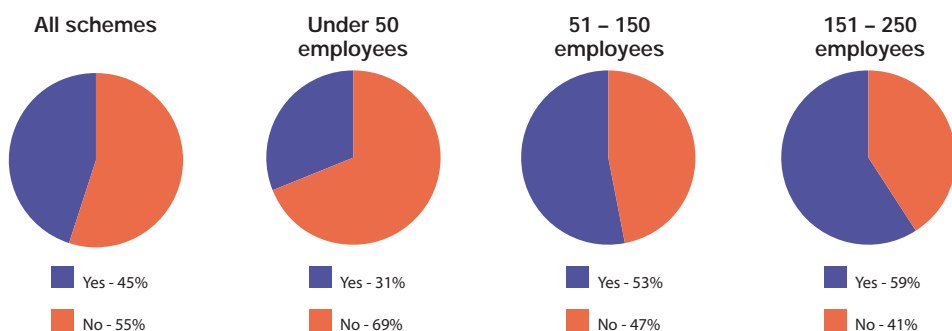
Reduced personal and corporate tax rates would seem to be one important prerequisite, alongside a return to stable and consistent earnings growth above the levels of real inflation experienced by these groups.

personal accounts: most firms say existing schemes will fail exemption test

The survey found 55% of firms who said their existing pension scheme was not sufficient to secure exemption from personal accounts. To secure exemption, firms will have to offer to all employees over age 22 a scheme where the employer contributes at least 3% of band earnings (between approximately £5,435 to £36,000

per annum – 2008/09 figures, to be updated to maintain their value) and the combined employer and employee contribution, including tax relief must be at least 8% of these band earnings (note: the calculation is based on overall earnings, including items such as overtime, bonuses and commission, not just basic salary).

Figure 7: Percentage of firms with pension scheme(s) that offer for all employees over age 22 a scheme that is at least as good as the proposed personal accounts scheme



Of those firms saying their existing scheme will fail the test, close to a half said this was because of restrictions in eligibility rules to join schemes and 63%

said that their contribution levels (most notably in the smallest firms with 50 or fewer employees) fall below the personal account minimum levels.



Amongst the 1 million firms employing 50 or fewer staff, less than 1 in 5 offer a workplace pension scheme.

auto-enrolment and opt-outs: 31% of firms may reduce benefits or abandon existing pension schemes

Only 6% of firms in our sample auto-enrol employees into their pension scheme. On average, the survey found 38% of employees have not joined schemes, or have actively opted out, where these are considered to be of exempt standard (i.e. better than personal accounts). However, participation rates overall, including all schemes covered by the survey, are considerably lower at 45% of eligible membership.

Under the new legislation, firms that wish to be exempted from personal accounts must meet the minimum contribution

standards and auto-enrol all employees aged 22 or over into an existing or new scheme or schemes.

The survey examined firms' responses to auto-enrolment and found:

- 31% of firms would reduce scheme benefits (to mitigate the cost of higher membership) or would close their scheme in favour of personal accounts. Amongst the smallest firms (under 50 employees) this rises to 38%.
- Only 28% of firms said they are

prepared to enrol all employees into their defined contribution scheme without reducing benefits (none were prepared to do this into a defined benefit scheme!).

- A third of employers expect to restrict entry to their own work-based scheme, presumably on the basis that this attracts contributions (or benefits) above those offered by personal accounts, with the balance of employees being offered personal accounts. Whether this division of the labour force is either advisable, or is administratively practical, only time will tell.

Figure 8: If auto-enrolment is required by Government from 2012, what will be the likely response of firms?

	Yes
We will probably restrict entry to our firm's scheme and auto-enrol the balance of employees into personal accounts	32%
We will probably opt-in all employees to the firm's existing defined contribution scheme, so we will avoid introducing personal accounts	28%
We will probably close our firm's scheme(s) so all employees would then opt-in to personal accounts	19%
We will probably opt-in all employees to the firm's existing scheme so we will avoid introducing personal accounts, but we will mitigate against the higher scheme membership from auto-enrolment by reducing benefits	12%
We have no firm's scheme, so in 2012 we would opt all employees into personal accounts	9%
We will probably opt-in all employees to the firm's existing defined benefit scheme so we will avoid introducing personal accounts	-

Figure 9: Firms presently offering a pension scheme: estimates of how many individuals will continue to opt-out of either employer-sponsored schemes or personal accounts after 2012

SIZE OF FIRM	Percentage opting-out from employer-sponsored schemes	Percentage opting-out from personal accounts
1-50 employees	39%	46%
51-150	31%	38%
151-250	26%	31%
All	34%	40%

Overall, firms with existing pension schemes expect participation rates through auto-enrolment to increase on average from around 45% to 66% (effectively, a near 50% increase in take-up). Post-2012, their expectation is that opt-outs will range from 34% in employer sponsored schemes through to 40% where personal accounts are offered instead.

However, among firms where there is no employer sponsored scheme at present,

75% of these firms expect opt-out rates to exceed 40%.

Affordability, once again sits at the top of the list of why opt out rates will be at these levels. Interestingly, given the number of press articles on this subject, 'concern over the loss of means-tested benefits in retirement' figures only fourth in the list.

These estimates of opt out levels could, of course, be influenced by the

communications strategy running up to 2012, one way or the other, and certainly by economic conditions. As things stand, the opt-out estimates suggest that personal accounts may increase workplace pension coverage by some 4 – 6 million, somewhere between the pessimistic and central scenarios modelled by the Pensions Policy Institute (see: *Will personal accounts increase pension saving?* published by the Pensions Policy Institute, November 2007).

However, total pension coverage may increase by considerably less than this as it is estimated that presently 2 million employees are saving in personal pensions but not also in a work-based scheme. Many of these individuals could move from a personal pension into either personal accounts or some other employer sponsored scheme that is on offer, probably with higher contributions overall. Also, with the smallest firms predicting higher opt out rates, the impact of this could be to pull down the number of extra pension savers to the lower end of the forecasts.

views on pensions reform: two-thirds of firms see levelling-down and scheme closures as likely outcome

The survey examined views on the likely outcome of the Government's latest key pension reforms (introducing auto-enrolment and personal accounts from 2012).

Two-thirds of firms said that, as a result of the reforms, they expected a general

levelling-down in per capita pension contributions from firms that presently offer superior schemes to personal accounts. Presumably, this view is based on the additional costs that will otherwise arise from higher levels of participation (net of opt outs) in these schemes due to auto-enrolment. Therefore, the

expectation seems to be that levelling-down will be more prevalent where there are more schemes above the exemption level of personal accounts, presumably where there are larger employers with participation rates that are at present modest.

Figure 10: Firms' views on the Government's pension reform policies

Firms answering "yes"	All firms	1 – 50 employees	51 – 150 employees	151 – 250 employees
The Government's pension reforms will lead to a general levelling-down of pension contributions per employee by organisations presently offering better schemes	67%	64%	69%	72%
The Government's reforms will lead to an increase in the number of closures of existing schemes	63%	58%	66%	71%

Almost an equivalent number of schemes also expect the reforms to lead to an increase in scheme closures. This might be explained in a number of ways:

- many smaller firms may be reluctant to run more than one scheme if contribution levels between an existing scheme and personal accounts are broadly similar. Not

unreasonably, they may feel running just personal accounts would be simpler, rather than always having to compare their established scheme with the personal accounts rules.

- other firms may be reluctant to meet the 'unknown' extra cost of a much higher level of scheme participation through auto-enrolment

into their existing scheme and will take the view that the run-up to 2012 is an appropriate time to review their benefits package. This may lead onto the closure of an existing defined contribution (or defined benefit) scheme in favour of a lower-cost scheme or to reliance thereafter on personal accounts.

conclusion: survey results suggest immense challenges ahead to make reforms work

We would not be where we are but for good reasons. Changing the dynamics that have taken us to where we are and extending pension provision to more employees across a wider swathe of enterprises is a laudable objective and one that must be welcomed by all. But the challenges and difficulties cannot be ignored – they have to be addressed.

This first report on the results of the *2008 ACA Smaller Firms Pension Survey* highlights not only 'where we are', but also the fragility of pension provision in smaller firms: firms where the success or failure of the Government's latest reforms to a large degree will lie. The Government led Stakeholder pension reforms introduced just 7 years ago have after all largely failed, with a low take-up and with many smaller employers simply ignoring the letter of the law. Hence, these next step reforms.

However, this latest survey suggests that the bench-mark for personal accounts and auto-enrolment may have been set at a very challenging level for many smaller firms and could well, as a result, lead to extensive levelling-down of existing schemes and scheme closures. That would be a worrying outcome, particularly if it also is accompanied

by high levels of opt outs post-2012.

Three other factors may also drive the outcome of these latest reforms in the smaller firms sector.

First, the administrative workability of the personal accounts scheme, certainly within existing timetables, remains almost totally unknown. Over the next two to three years, we will see just how possible it is to build a theoretical structure that meets the challenge of administering the ebbs and flows at over a million firms and at what cost. We will then have to wait a little longer to see if the practice can match the theory. A major failure in administration at an early stage could be devastating to the success of the policy.

Second, the communication campaign in the run up to the launch of how this (simple!) scheme will work must be much more effective than that for Stakeholder pensions. Inevitably, it will need to address the issue of how small pots might impact on State benefits in retirement. How, in that communication, the genuine need for individual advice will be addressed remains unclear, particularly given the disappointing outcome detailed in recent reports on what has been achieved by financial

education programmes.

Third, and probably most important, is the economic backcloth against which the personal accounts scheme is launched. If economic conditions are tough, it is clear from the survey results that opt-outs from schemes will be at a higher level than if conditions are more benign. The level of opt-outs will be important from an early stage and will drive everyone's confidence in the sustainability of the reforms. If current economic conditions continue, some delay beyond 2012 has to be considered. For the majority of smaller firms starting, as they are, from a base of no employer or employee pension contributions at all, the success of the launch is much more likely if this is at a time when both personal and corporate taxes are being gradually reduced to meet the phased introduction of contributions, presently over three years. Unfortunately, as things stand, it is difficult to see when or if this particular window of opportunity might appear in the foreseeable future.

A second report, including all the statistical data behind these results will be published in the autumn of 2008. For further details contact the Association of Consulting Actuaries on 020 7382 4594 or email acahelp@aca.org.uk



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